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LEVERAGED BUYOUTS AND CORPORATE DEBT

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BEFORE THE

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UNITED STATES SENATE

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LEVERAGED BUYOUTS AND CORPORATE DEBT

THURSDAY, JANUARY 26, 1989

U.S. SENATE,
COMMITTEE ON FINANCE,
WASHINGTON, DC

The hearing was reconvened, pursuant to recess, at 10:00 a.m., in Room SD-215, Dirksen Senate Office Building, the Hon. Lloyd Bentsen (chairman) presiding.

Present: Senators Bentsen, Baucus, Daschle, Packwood, Danforth, Chafee, Heinz, Durenberger, Armstrong and Symms.

[The press release announcing the hearing follows:]

[Press Release No. H-1, December 12, 1988]

BENTSEN ANNOUNCES FINANCE COMMITTEE HEARINGS ON LEVERAGED BUY-OUTS AND CORPORATE DEBT

WASHINGTON, DC—Senator Lloyd Bentsen (D., Texas), Chairman, announced Wednesday that the Committee on Finance will hold hearings on the recent trend in corporate restructurings, mounting debt in the corporate sector, and the relationship of these trends to the tax law.

The hearings are scheduled for *Tuesday, January 24, Wednesday, January 25, and Thursday, January 26, 1989 at 10:00 a.m.* in room SD-215 of the Dirksen Senate Office Building.

Bentsen said, "The recent trend of corporate leveraged buyouts and other corporate restructurings is troubling and deserves a closer look. In particular, the massive corporate conversion of equity to debt causes me concern about the ability of our country's corporations to weather an economic downturn. I am also concerned about the possible adverse effects of this mounting debt on Federal tax revenues, at a time when reducing the budget deficit is a critical priority."

"One cause for this trend may be our tax system's bias in favor of debt financing, as opposed to equity financing. I intend to examine this problem and explore the possibilities for reform. Additionally, I would like to determine whether any other aspects of the tax system may artificially encourage those sorts of transactions. These issues are complex and I look forward to a fruitful series of hearings on the subject."

OPENING STATEMENT OF HON. LLOYD BENTSEN, A U.S. SENATOR FROM TEXAS

The CHAIRMAN. I know that these hearings have added to my sum of knowledge insofar as leveraged buyouts. I believe they have been educational to others as well. And what we have been striving to do here is to develop the kind of background information to determine some of the broad policies that can be effected if we take legislative action.

There has been healthy disagreement, and I expect more of it, particularly today; but I haven't heard any disagreement on one point, that the U.S Tax Code favors debt.

The hearings have reinforced my concern about the need to even out the attractiveness of debt and equity, though we as yet haven't figured out how to do that.

I was interested in Chairman Ruder's observation about the free market system. He said the government shouldn't pick and choose, that that is a function of the free market. And I couldn't agree with him more, insofar as that goes. But the fact is, I think government has picked debt, the government has chosen to give an advantage to debt over equity. The question is, how do we address that? How do we neutralize this picking? And what is the effect of choosing?

We are moving toward an answer to that question. We are not there yet, and I have a hunch when we get there, with the budget constraints that we have otherwise, that whatever we do will not be all that dramatic.

As Professor Summers was saying yesterday, the current tax system provides substantial incentives for the excessive use of debt. I think that is the key word, the word "excessive." We are not saying there shouldn't be debt, and that debt is bad per se. Without debt, a lot of the largest corporations in America wouldn't be in existence today. But our concern is with the excessive corporate debt and with that burden that might be brought about if we go into another recession, making it deeper, longer, or having more bankruptcies.

You might use the analogy of crash helmets. Some States require motorcycle riders to wear helmets, and some don't. But none of the States penalize a rider for wearing one of them. The Tax Code not only encourages business to take the riskier road of debt, it penalizes those who take the safe path of financing through equity, and I believe that is a mistake.

We are going to hear in today's hearings from those who suggest that the risk of debt may extend beyond the private sector to the Federal Government. The 1986 Tax Reform law didn't cause the savings and loan crisis, but there are those who think that it made it worse.

They say the new tax law includes some rules that drove down the value of real estate, which S&Ls depend on for their collateral. Now American taxpayers, one way or another, are going to have to bail out the S&L industry.

I am looking forward to what the witnesses have to say today. We have an outstanding group of witnesses again. We are just delighted our first witness leading off is going to be the Chairman of the Federal Reserve Board, Dr. Alan Greenspan. And then, we will hear from Dr. Kathy Utgoff, the Executive Director of the Pension Benefit Guaranty Corporation. Mr. Lane Kirkland,the head of the AFL-CIO, will be our third witness. After Mr. Kirkland we will hear from John Creedon, and Mr. Bruce Smart, two businessmen who take a less sanguine view, as I understand it, about LBOs than did Mr. Lee and Mr. Kidder yesterday. Finally, we will hear about the empirical studies of Professor Steven Kaplan of the University of Chicago Business School.

But before we proceed, I would like to defer to my distinguished colleague Senator Packwood for any comment he might make.

OPENING STATEMENT OF HON. BOB PACKWOOD, A U.S. SENATOR FROM OREGON

Senator PACKWOOD. Mr. Chairman, thank you very much.

I simply want to read a portion of an article and then submit the rest of it for the record. The article was written by Roger Meier in Oregon. Roger Meier was for 16 years the head of the Public Employee Retirement System Investment Council—a private citizen giving his time, supervising the investment of the pension funds and surplus funds of the State of Oregon.

During that time, the pension fund was participated in a number of leveraged buyouts, and he said we were required to invest our money prudently, and we clearly did. I want to read just about one of the companies that was involved, because this was a Kohlberg Kravis Roberts buyout of Fred Meyers, which is Portland's largest retailer, larger than Safeway in Oregon. I will read as follows:

"Before the LBO, Fred Meyer had received many inquiries from potential buyers, who most likely would have dismantled the company, changed its strategic direction, and moved the corporate headquarters away from its long-time home in Portland."

I would add, parenthetically, here: The founder of the company, Fred Meyer, had run it personally for, I would judge, the better part of 60 years, and really it was not corporately run in the normal sense you think of "corporate management." It was his, he founded it, and while it was a public corporation, he ran it. But as he was reaching his elder years—he may have died by that time; I can't remember—the question was what was going to happen to the company.

"An LBO allowed the company to continue its strategy and commitment to grow in the State and throughout the Nation."

"Since the LBO in 1981, Fred Meyer has added 64 stores in four States, a 76 percent increase in store square footage that brings its total presence today to 112 stores in seven States. The company has added 12 new stores in Oregon alone and undertaken major remodeling efforts at 19 others. Growth has occurred both in the Portland area and in many rural areas of the State that were suffering from a recession in the forest products industry."

"The company has spent $300 million on capital expenditures, including upgrading truck fleets and investing in new computer systems. Fred Meyer's charitable contributions during those seven years totalled $13,500,000."

"Fred Meyer's employment has jumped from 11,000 just prior to the LBO to nearly 19,000— a jump of more than 70 percent. The company's employment in the State has increased more than 50 percent, from 6800 to 10,300 people. The company's performance has been excellent since the LBO, with sales and income improving every year."

"And in 1986 Fred Meyer completed an initial public stock offering, giving the citizens of Oregon, along with other investors, the chance to realize ongoing value from equity ownership as well."

Then he concludes by saying, "The Fred Meyer experience is not unique. We could tell similar stories and cite similar statistics for virtually all companies in which we're invested."

I would ask, Mr. Chairman, that this letter in its entirety appear in the record.

The CHAIRMAN. Without objection, that will be done.

[The letter appears in the appendix.]

The CHAIRMAN. Mr. Chairman, we are very pleased to have you. If you would, proceed.

STATEMENT OF HON. ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM; WASHINGTON, DC

Chairman GREENSPAN. Thank you very much, Mr. Chairman.

I will excerpt from my prepared remarks but request that the full set of remarks be included in the record.

[The prepared statement appears in the appendix.]

Chairman GREENSPAN. Mr. Chairman, Members of the Committee, I am pleased to be here to address issues raised by recent trends in corporate restructuring activity.

While the evidence suggests that the restructurings of the 1980s probably are improving, on balance, the efficiency of the American economy, the worrisome and possibly excessive degree ofleveraging associated with this process could create a set of new problems for the financial system.

The recent period has been characterized by the retirement of substantial amounts of equity, actually more than $500 billion since 1983, which has been mostly financed by borrowing in the credit markets.

The accompanying increase in debt has resulted in an appreciable rise in leverage ratios for many of our large corporations. Aggregate book value debt-equity ratios, based on balance sheet data for nonfinancial firms, have increased sharply in the 1980s, moving outside their range in recent decades, although measures based on market values have risen more modestly.

Along with this debt expansion, the ability of firms in the aggregate to cover interest payments has deteriorated. The ratio of gross interest payments to corporate cash flow before interest provision is currently around 35 percent, close to the 1982 peak when interest rates were much higher, and very significantly above what it was a decade or two ago. Moreover, current interest coverage rates are characteristic of past recession periods, when weak profits have been the culprit. Lately, profits have been fairly buoyant; the current deterioration has been due to heavier interest burdens.

A measure of credit quality erosion is suggested by an unusually large number of downgradings of corporate bonds in recent years. The average bond rating of a large sample of firms has declined since the late 1970s from an A+ rating, on average,to an A- rating. That is a very significant change in the underlying quality structure.

To fashion an appropriate policy response, if any, to this extraordinary restructuring LBO phenomenon, there are some key questions that must be answered: What is behind the corporate restructuring movement? Why is it occurring now, in the middle and late 1980s, rather than in some earlier time? Why has it involved such a broad leveraging of corporate balance sheets? And finally, has it been good or bad for the American economy?

The 1980s has been a period of dramatic economic changes: large swings in the exchange value of the dollar, with substantial consequences for trade-dependent industries; rapid technological progress, especially in automation and telecommunications; rapid growth in the service sector; and large movements in real interest rates and relative prices. Clearly, such changes in the economic environment imply major, perhaps unprecedented, shifts in the optimal mix of assets at firms—owing to corresponding shifts in synergies—and new opportunities for improving efficiency. Some activities need to be shed or curtailed, and others added or beefed up. Moreover, the long period of slow productivity growth in the 1970s may have partly exacerbated the buildup of a backlog of inefficient practices.

When assets become misaligned or less than optimally managed, there is clearly an increasing opportunity to create economic value by restructuring companies, restoring what markets perceive as a more optimal mix of assets.

Back in the early 1970s and the late 1960s, for example, we saw that our oil industry was essentially structured with certain combinations of crude oil reserves, on the one hand, and very elaborate refining/marketing complexes on the other. At that time, that was perceived of as the relatively optimal mix for maximum efficiency and profitability.

When the price of oil went from $3 to $30 a barrel, a set of circumstances was created in which the same balance of crude oil reserves on the one hand and refining, marketing and other characteristics of oil companies on the other, no longer made economic sense.

As a consequence of that, there were, and continue to be, for such types of events, significant endeavors to unwind the structure which is no longer optimal and put it back together with different combinations in a manner which significantly enhances economic value. But in order to do that restructuring, one requires gaining control of the corporation. And managers, unfortunately, often have been slow in reacting to changes in their external environment—some more than others.

Hence, it shouldn't be a surprise that in recent years unaffiliated corporate restructurers—some call them "corporate raiders"—have significantly bid up the control premiums over the passive investment value of companies that are perceived to have sub-optimal asset allocations.

If a company has an optimal mix, there is obviously no economic value to be gained from restructuring and, hence, no advantage in obtaining control of a company for such purposes. In that case, there is no incentive to bid up the stock price above the passive investment value based on its existing, presumed optimal, mix of assets. But in an economy knocked partially off kilter by real interest rate increases and gyrations in foreign exchange and commodity prices, there emerged significant opportunities for value-creating restructuring at many companies.

This presumably explains why common stock tender-offer prices on potential restructurings have risen significantly during the past decade. Observed stock prices generally, though not always, reflect values of shares as passive investments—meaning you invest, and all you get is the dividend; you have no ability to control how that company is operated. But there are, for any individual company, two or more prices for its shares, reflecting the degree of control over a company's mix of assets.

Tender-offer premiums, which are good proxies of these control premiums, ranged from 13 to 25 percent in the 1960s but have now moved up to 45 percent and higher during the past decade, underscoring the evident increase in the perceived profit to be gained from corporate control and restructuring.

Interest in restructuring also has been spurred by the apparent increased willingness and ability of corporate managers and owners to leverage balance sheets. The gradual replacement of managers who grew up on the Depression and developed a strong aversion to bankruptcy risk probably accounts for some of the increased proclivity to issue debt now—that is, to leverage.

I remember back in the 1950s, when most of the academicians demonstrated that in fact we were underleveraged and not using debt in an appropriate way, that most corporate managers basically remained extraordinarily conservative, because back in their history was an awareness of what the risk of excessive debt was. As they have retired and faded from the scene and we are getting, now, managers who are essentially involved only in the post World War II period, one senses that the actual practice in leveraging is moving up to what academics think is optimal. And I think that is a major factor in why we have had such a dramatic increase in the ratio of debt to equity in the post World War II period.

Moreover, innovations in capital markets have made the increased propensity to leverage feasible. It is now much easier than it used to be to mobilize tremendous sums of debt capital for leveraged purchases of firms. Improvements in the loan-sale market amongst banks and the greater presence of foreign banks in the United States markets have greatly increased the ability of banks to participate in merger and acquisition transactions. The phenomenal development of the market for low-grade corporate debt, so-called "junk bonds," also has enhanced the availability of credit for a wide variety of corporate transactions.

The tax benefits of restructuring activities are, of course, undeniable, but this is not a particularly new phenomenon. Our tax system has long favored debt finance by taxing the earnings of corporate debt capital only at the investor level, while earnings on equity capital are taxed at both the investor and corporate levels.

There have been other sources of tax savings in mergers that do not depend on debt finance, involving such items as the tax basis for depreciation and foreign tax credits. And taxable owners benefit when firms repurchase their own shares, using what is, in effect, a tax-favored method of paying cash dividends. In any event, the recent rise in restructuring activity is not easily tied to any change in tax law.

Evidence about the economic consequences of restructuring is beginning to take shape, but much remains conjectural. It is clear that the markets believe that the recent restructurings are potentially advantageous. Estimates range from $200 billion to $500 billion or more in paper gains to shareholders since 1982. These gains are reflections of the expectations of market participants that the restructuring will, in fact, lead to a better mix of assets within companies and greater efficiencies in their use. This, in turn, is expected to produce marked increases in future productivity and, hence, in the value of American corporate business. Many of the internal adjustments brought about by changes in management or managerial policies are still being implemented, and it will take time before they show up for good or ill in measure of performance.

So far, various pieces of evidence indicate that the trend toward more ownership by managers and tighter control by other owners and creditors has generally enhanced operational efficiency. In the process, both jobs and capital spending in many firms have contracted as unprofitable projects are scrapped. But no clear trends in these variables are yet evident inrestructured firms as a group. For the business sector generally, of course, growth of both employment and investment has been strong.

If what I have outlined this morning is a generally accurate description of the causes of the surge in restructurings of the past decade, one would assume that a stabilization of interest rates, exchange rates, and product and commodity prices would slow the emergence of newly misaligned companies and opportunities for further restructuring. Such a development would presumably lower control premiums and reduce the pace of merger, acquisition, and LBO activity.

This suggests that the most potent policies for defusing the restructuring LBO boom over the long haul are essentially the same macroeconomic policies toward budget deficit reduction and price stability that have been the principal policy concerns of recent years.

Whatever the trends in restructuring, we cannot ignore the implications that the associated heavy leveraging has for broad-based risk in the economy. Other things equal, greater use of debt makes the corporate sector more vulnerable to an economic downturn or a rise in interest rates. The financial stability of lenders, in turn, may also be affected.

Most of the restructured firms appear to be in mature, stable, non-cyclical industries. For such businesses, a substantial increase in debt may raise the probability of insolvency by only a relatively small amount. However, roughly two-fifths of merger and acquisition activity, as well as LBOs, have involved companies in cyclically sensitive industries that are more likely to run into trouble in the event of a severe economic downturn.

Lenders to leveraged enterprises have been, in large part, those that can most easily absorb losses without major systemic consequences. They include mutual funds, pension funds, and insurance companies, which generally have diversified portfolios, have traditionally invested in securities involving some risk, such as equities, and are not themselves heavily leveraged. To the extent that such debt is held by individual institutions that are not well diversified, there is some concern. At the Federal Reserve, we are particularly concerned about the increasing share of restructuring loans made by banks. Massive failures of these loans could have broad implications.

However, we must resist the temptation to seek to allocate credit to specific uses through the tax system or through the regulation of financial institutions. Restrictions on the deductibility of interest on certain types of debt or on the granting of certain types of loans unavoidably involve an important element of arbitrariness, one that will affect not only those types of lending intended but other types as well. Moreover, foreign acquirers could be given an artificial edge to the extent that they could avoid these restrictions. Also, historical experience with various types of selective credit controls clearly indicates that, in time, borrowers and lenders find ways around them.

All that doesn't mean that we should do nothing. The degree of corporate leveraging is especially disturbing in that it is being subsidized by our tax structure, as the Chairman points out.

To the extent that the double taxation of earnings from corporate equity capital has added to leveraging, debt levels are higher than they need, or should, be. Our options for dealing with this distortion are, unfortunately, constrained severely by the Federal Government's still serious budget deficit problems.

One straightforward approach to this distortion, of course, would be to substantially reduce the corporate income tax. Alternatively, partial integration of corporate and individual income taxes could be achieved by allowing corporations a deduction for dividends paid or by giving individuals credit for taxes paid at the corporate level. But these changes taken alone would result in substantial revenue losses to the Treasury. A rough estimate of IRS collections from taxing dividends is in the $20 to $25 billion range annually.

Dangers of risk to the banking system associated with high debt levels also warrant attention. The Federal Reserve, in its role as a supervisor of banks, has particular concerns in this regard. In 1984, the Board issued supervisory guidelines for assessing LBO-related loans. The Federal Reserve is currently reviewing its procedures for evaluating bank participation in highly leveraged financing transactions. The circumstances associated with highly leveraged deals require that creditors exercise credit judgment with special care. Doing so entails assessing those risks that are firm-specific as well as those common to all highly leveraged firms.

Thank you very much, Mr.Chairman.

[The prepared statement of Chairman Greenspan appears in the appendix.]

The CHAIRMAN. Thank you very much, Mr. Chairman.

While I certainly agree with what the witnesses have stated, we don't want to stop LBO's per se. The question is about the massive move toward increased debt in our economy that is used for these transactions.

I am delighted to hear your comments about the banks. I was looking at Standard and Poor's reports about how much some banks have moved toward financing leveraged buyouts. I noted that the portfolios of at least a couple of the major banks for LBO financing have gone to almost—well, for one of them, in particular—24 percent of its domestic business loans. This bank has over $3 billion of LBO loans.

I assume that has to cause you some concern, too, and that is why you are talking about further guidelines for them.

Chairman GREENSPAN. That is correct, Mr. Chairman.

The CHAIRMAN. Now, you have discussed some of the alternatives insofar as trying to even out the attractiveness of equity and debt. Do you have any others that we can do from a legislative standpoint, with the idea that we have a massive budget deficit to contend with?

Chairman GREENSPAN. I wish I could find simple answers, as I am sure the committee would as well. The only thing that concerns me about these leveraged buyouts and other restructurings is the extent to which they are or are not subsidized by our tax system. If they are activities wholly involved in the market with no subsidies, looking to create value, the restructurers, the LBO generators, may or may not be right in what they are endeavoring to do, but they are seeking to improve the structure of companies and the economy.

The problem that I have with them is, twofold. First, that some are being subsidized through the tax system. To the extent that they are tax subsidized, they are not adjusting to market signals.

Second, as a consequence of the bias in our tax system, we are getting a very large ratio of new debt to new equity in the system.

A number of commentators have argued that current debt and debt-service levels are not dangerous, but actually represent reasonably good nonfinancial corporate behavior.

Our problem is what will happen if we continue what we are doing, projecting it indefinitely into the future, because then we surely will leverage to the point of being dangerous.

The CHAIRMAN. I would agree with you.

Now, you discussed those things that can be done and are politically attractive to do insofar as reducing the tax rate for corporations or giving a credit of the corporate tax paid to the dividend receiver; but we are in an era of massive budget deficits. And just as in the catastrophic illness bill that we passed here, we resorted to a new means of financing, and tried to see that it came as close to budget-neutral as we thought we could accomplish and still render the service to that particular age group on catastrophic illness, and in that instance left those people paying the most still receiving a 30 percent subsidy.

But are there means, of picking up some revenue to pay for giving credits on dividends received, or whichever option we choose from that standpoint, to balance it off in raising revenue on the other side, in some denial of the interest deduction, that accomplishes our objective within the limitations of the budget problems we face?

Chairman GREENSPAN. Well, Mr. Chairman, we have gone through an exercise in which we asked precisely that question, just to see what the arithmetic and the budget implications are. We concluded that eliminating the interest deduction is the equivalent of reducing the corporate tax rate from 34 percent to a little over 24 percent. So that there is a great deal—it is about a 10 percentage point equivalent of the corporate tax in the corporate interest deduction item.

Senator PACKWOOD. You have lost me. Would you explain that again?

Chairman GREENSPAN. This is strictly an arithmetical exercise, and I will get to the reason why I use the word "arithmetical" as distinct from "economic."

We asked the question, "What is the equivalent of eliminating the interest deduction on corporations in the corporate tax rate?"—in other words, to be revenue neutral—

Senator PACKWOOD. Oh. Okay.

Chairman GREENSPAN. It is the equivalent of almost 10 percentage points. However, if one actually endeavored to do that—in other words, basically said that interest was no longer deductible, and we will cut the corporate rate by 10 points to offset it—it would be a significant revenue loser. And the reason is that a number of corporations would sell assets and pay off their debt, which would reduce their interest deductions.

Or put it the other way around: corporations are holding assets because they have the interest deduction. So, what would occur is some significant loss of revenue, if you eliminated the interest deduction, and tried to offset that by reducing corporate tax rates. And we have rejected that as a reasonable notion.

However, if Congress can find means to create credits for dividends received on the individual tax form, I think that would be helpful.

You may recall, Mr. Chairman, that several years ago, in the examination of taxes which eventually became the 1986 Act, there was a good deal of evaluation of this, and I think that it might be useful for this committee to go back and look at some of that earlier information.

The CHAIRMAN. That is right. But at that time—if I may just respond to that—when we talked about first giving the credit to the corporation, and then moved from that to giving the credit to the recipient of the dividend, as you are speaking of now, we began to see a division in corporate support for it, and we did not have the kind of support that one would hope for.

And yet, as I have studied other countries and what they do, in general they do not give it to the corporation on the dividend paid, it is given to the recipient of the dividend, with perhaps a 50 percent credit as related to the tax paid by the corporation that year.

I see my time has expired. We will follow the early bird rule. I note the arrivals were Senators Heinz, Symms, Packwood, Durenberger, Baucus, Danforth, and Daschle. Senator Heinz has gone, and so it is—Senator Packwood?

Senator PACKWOOD. As I recall, Mr. Chairman, I remember that battle. We ran into an argument as to whether the corporation could deduct the dividends paid or the recipient got the credit, and it depended upon the kind of corporation you were.

Some corporations did not want the pressure from their shareholders to declare dividends; they were afraid they could not retain earnings with the pressure if the individual stockholders got the credit. The issue kind of fell apart because corporate America split on the subject.

I read your testimony and listened to it. Let me ask you if I summarized it right:

One, any information we have as to the effect of the LBOs is somewhat tentative; but, on balance, it seems to be they make the companies somewhat more efficient. Is that a fair statement?

Chairman GREENSPAN. Yes.

Senator PACKWOOD. Two, a good many of the people that are participating in the LBOs—such as pension funds or insurance companies—are experienced investors with a reasonably broad portfolio and could probably stand some kind of a downturn, unless the country just hit a traumatic depression, in which case everybody is affected. But many of them are experienced and their investments are broadly diversified.

Chairman GREENSPAN. Yes.

Senator PACKWOOD. You have some fear about the banks, however, and some of them perhaps getting too heavily involved in this kind of debt.

Four, you would like to see—and of course this recommendation has come frequently—some integration of dividends, whether by allowing a dividends paid deduction or a shareholder credit. Something that moves us a bit toward encouraging equity—I don't want to say discouraging debt but encouraging equity. But given the financial situation that we are in right now, you are not sure what to recommend, or not sure you can recommend anything, because of the budget problem.

Now, we are a committee that can either act or not act. What do you recommend we do? Or do nothing?

Chairman GREENSPAN. Well, let me just first say it is very clear you were listening closely, Senator, and said it a lot more succinctly than I did.

The leverage question and the subsidy that exists in our tax system favoring debt over equity is something which obviously predates the LBO issue. It is something which is undesirable for our system for reasons wholly independently of the LBO question, and I would not like us to address this particular issue—that is, the tax bias in the system—wholly in the context or even predominately in the context of LBOs.

I think it deserves to be evaluated in a much broader sense of how we tax capital income, and that is an issue which gets to deep-seated problems that we have in this country with respect to debt, equity, inadequate savings and investment, and a variety of issues which I think would be crucial issues on this question.

I would think, having evaluated this situation as best I can, that we are probably looking at the peak of this activity, assuming that we have a continued return to economic stability. I don't know that, I must say, and I wouldn't want to rest policy on it, but I think there is a reasonably good chance. I also think it is important to understand why this occurs so we can understand what to do about it. We have had this traumatic shock to the economy in the 1980s which, as I said in my prepared remarks, misaligned various companies and lowered their efficiency but created a possibility of regaining most of that loss by restructuring.

We have actually gone through, in my judgment, a very large part of that already. There is, in a sense, a backlog of needed restructurings—whether they are LBOs or other types of mergers or acquisitions is not particularly relevant—and it is quite possible, although I want to emphasize that the evidence here is very weak, it is more conjecture than fact—we probably have gone through a large part of what we have to go through and that this activity normally will just begin to recede.

This would lead me to try to do very little with respect to legislation but a lot with respect to supervision, especially in the banking, to make certain that this process does not create significant problems for our financial institutions.

However, having said that, and leaving the issue aside of LBOs particularly, the rise in debt is worrisome. And to the extent that we can come to the tax issue relatively quickly, I think that would be desirable; but I would not, Senator, make it an issue of LBO adjustment.

Senator PACKWOOD. Do you think, Mr. Chairman, if we came to grips with that debt-equity issue and did something to tilt toward equity, it would make the debt levels go down?

Chairman GREENSPAN. No, I don't think it would make the debt-equity levels go down, but I think it would change the ratio of net new debt to net new equity, which would probably eventually take the rising debt-equity ratio and flatten it out, which in my judgment probably would be adequate for concerns that I would have relevant to leverage.

Senator PACKWOOD. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Baucus?

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Chairman, if I could follow up on that a little bit, you said earlier in your statement that the tax consequences might have something to do with this growing phenomenon; but, as I understood you, there are probably deeper, more fundamental reasons that explain it. You mentioned changing economies; you mentioned that managers tend to be a bit slow in responding to the changes; you mentioned that there are some inefficient assets in corporate America; and you mentioned that outsiders saw these inefficiencies and found ways to make the assets a little more efficient. And essentially, that tends to be, if not "the" driving force, one of the major forces in this phenomenon.

If that is true, and if it is also true that changing the interest deduction would make future debt a little less attractive, and that the result would be different debt-equity ratios, wouldn't it make sense for Congress to begin moving in that direction?

It seems if we want to slow down this accelerated growth of debt versus equity, that perhaps it makes sense for us to take a step—hopefully not too much of a step, but a step—to address that problem.

Chairman GREENSPAN. Oh, sure. I don't think there is any question. If we could wave a wand at this stage and integrate the individual and corporate income tax, or eliminate the corporate tax completely, for example, that resolves the subsidy issue, completely.

The trouble is that there is no way of doing that in today's environment, but I do think that if one could move in that direction, without large budgetary funds, or perhaps do it prospectively—in other words, look towards not 1990 but 1992, for example—if we could do that, it is something which would be most helpful.

Senator BAUCUS. You are not opposed, then, to a prospective application of some kind of properly tailored reduction of interest deduction?

Chairman GREENSPAN. Well, I would tend to emphasize credits on the equity side, because I am concerned that, with an endeavor to significantly alter the deductibility of interest, we will create a number of other secondary effects, which are not perfectly clear at this stage, which may be adverse.

It is very difficult to find adverse secondary consequences from reducing the double taxation of dividends.

I must say, parenthetically, that the Tax Reform Act of 1986 was a major improvement in the tax structure. To the extent that any of this puts back on the table issues which were resolved in a very difficult way in that Act, I would feel quite uncomfortable. In other words, great progress has been made; let us not lose it.

Senator BAUCUS. Could you address the point made by many people who oppose congressional action; namely, that limiting the interest deduction would put the United States in an adverse competitive position vis-a-vis our international competitors? And to what degree you think that would be the case?

Chairman GREENSPAN. Well, it is difficult to say. Clearly, since interest is deductible abroad by foreign corporations, they would have an advantage over American corporations in competing to purchase American assets.

However, remember that there are a lot of other elements involved. The underlying net after-tax cost of capital is significantly lower, for example in Japan, than here, and no matter what we did on this question, we wouldn't close that particular gap.

So it is an issue. I would not say it is an overriding issue; namely, the question of the interest deductibility that exists in foreign corporations versus non-interest deductibility for American corporations. It is an issue; it creates competitive problems; but I wouldn't want to make it an overwhelming issue.

Senator BAUCUS. Some suggest limiting the interest deduction and taking some of that revenue and applying that to a credit on the dividends received, for example. What is your reaction to that?

Chairman GREENSPAN. Well, I feel a little uncomfortable about tampering with the interest deductibility, because I am not certain what the consequences are. I would prefer to find a means to lower that $20 to $25 billion annual tax on dividends.

Senator BAUCUS. Thank you.

The CHAIRMAN. Senator Symms?

OPENING STATEMENT OF HON. STEVE SYMMS, A US SENATOR FROM IDAHO

Senator SYMMS. Thank you very much, Mr. Chairman.

Mr. Greenspan, I have been very impressed with your statement this morning and your sensitivity to the structure of production. I know, from reading your earlier works over the years, that you have certainly been a student of Von Mises and Hayek, and I appreciate your sensitivity to that.

I have been very concerned during these hearings that if we got reckless in trying to change the tax deductibility of interest it would change the market capitalization of certain companies, and their share prices would collapse on the stock market. It could create some kind of pandemonium just due to some action of Congress. Do you think that there is any merit to that concern?

Chairman GREENSPAN. Certainly, if we reduced the double taxation of dividends, it would be positive rather than negative.

Senator SYMMS. Right. That would be. But to take away the deductibility?

Chairman GREENSPAN. Clearly, the effect on huge numbers of corporations would be very substantial. And I don't think that there have been any recommendations before this committee or others to do anything radical, or to do anything radical without a long phase-in.

I think, if one's basic purpose was to minimize market value implications, that could be done. My main concern is that there are secondary consequences that I don't think we could figure out in advance. As I said, to Senator Baucus, I don't feel comfortable with removing any of the deductibility of interest. If it were done, and it were done over a long period of time and phased out, I suspect its market implications would not be large. But one does not know that. Clearly, on efficiency grounds, the argument for solving the debt-equity subsidy problem from the dividend side, solely, is overwhelming.

Senator SYMMS. On a little different subject: In Senator Bentsen's, the Chairman's, first question he brought up the issue of the debt situation that many of the banks are in, financing LBOs but, in general, if we consider the high level of corporate debt across the board, I have noticed that the Federal Funds Rate has been creeping up as a result of the Fed's open market committee policy.

You have expressed here this morning sensitivity to what the impact of that policy is on the debt-equity ratios in business and the industrial sector of our economy. Does this worry you at the Fed, that as the private debt and America's dependency on it is larger than it has been, that it then takes away one of the Fed's favorite tools to offset inflation by letting the Fed Funds Rate creep up and dampen inflationary pressures?

Chairman GREENSPAN. Well, Senator, fortunately long-term interest rates have not moved up, due in part, to the expectation that inflationary pressures will not emerge and that inflation premiums embodied in long-term rates will remain relatively stable.

But clearly, when formulating monetary policy, the Federal Open Market Committee looks at all aspects of the economy, including such issues as you raise. So all I can say to you is that we try to look at the total picture, including the secondary feedbacks from our actions, in formulating policies.

So, a simple answer to your question is, yes, we do look at the consequences of what we do on various parts of the economy. And that is part of the process of developing monetary policy.

Senator SYMMS. Thank you very much.

Thank you, Mr. Chairman.

I would just say, in closing, Mr. Chairman, I think your statement is an excellent statement with respect to this LBO situation, and very informative. The thought occurred to me that I have a daughter majoring in economics in college; I think I will send it to her to study—it might help her out in her classes. It is an excellent statement, and thank you very much for it.

The CHAIRMAN. Senator Danforth?

OPENING STATEMENT OF HON. JOHN C. DANFORTH, A U.S. SENATOR FROM MISSOURI

Senator DANFORTH. Thank you, Mr. Chairman.

Mr. Greenspan, some people with whom I have spoken on this subject have said that one of the positive effects of leveraged buyouts is that there has tended, after the realignment, to be a greater interest by management in the ownership of the company. They have said that the trend—I don't know, 10 years or so ago—was larger and larger corporations, conglomerates, that management did not typically have a large equity stake in the corporation. Therefore, management was more interested in salaries and various perks of the office, and that, as a result, management tended to be short-range in thinking rather than long-range in thinking, because their own economic interest was not tied to the long-term growth of the business. Do you think that that analysis is a good one?

Chairman GREENSPAN. What we are doing is psychoanalyzing American corporate management.

Senator, I have sat on a large number of corporate boards in my career, and I have been quite sensitive to this issue. One would certainly say that, theoretically, the greater the proportion of equity that one has, the longer-term view one would have as a manager.

It is a theoretical notion. It is a psychological insight into the way people do things, but I can't honestly say that I have actually seen that process—meaning, large corporations being short-term when the managers held relatively small amounts of the corporate stock.

I am not sure that it is a big issue. I think that it probably does an injustice to a goodly part of the professional corporate management segment of this country.

However, there is no question that the more people are involved in an ownership relationship, the more attention the business gets. That has got to be inevitable.

Senator DANFORTH. You have testified at some length about the disincentives toward equity financing and the incentives to debt financing. And you have suggested—in fact, the thrust of your testimony has been—that, rather than to reduce the corporate interest deduction, you would prefer to provide more reason for corporations to rely on equity, and the one thing that you have suggested in this regard is some sort of dividend credit.

Why isn't restoration of the capital gains differential something that should be considered?

Chairman GREENSPAN. Well, I think that the capital gains tax is too high. The one aspect of the 1986 Act which I felt uncomfortable with was increasing the capital gains tax; but I understand it as part of a political compromise, which is part of a much broader issue.

But if you asked me, in the abstract, do I think we would be better off with a lower capital gains tax, would that be assisting this process? The answer is, yes, it would. It is one of a number of different elements to alter the balance between incentive for debt and incentive for equity which clearly should be considered.

I don't think, Senator, that there are novel or imaginative ways to come at this problem. I think we know what they all are, and we know roughly what impact they all do. The major problem is they all cost significant Treasury revenue, and I don't know how to get around this at this particular moment.

Senator DANFORTH. Well, I don't have the numbers in front of me, but I think that restoring the capital gains differential and creating some sort of credit for dividends paid would probably cost the Treasury about the same amount of dollars. If that is true, which would you prefer?

Chairman GREENSPAN. Let me think. See, the estimates that people make on the tax effect of a change in the capital gains tax is a very soft estimate. I would prefer to have both, if I may say that. (Laughter)

The CHAIRMAN. Thanks a lot, Mr. Chairman. You are right. Exactly.

Chairman GREENSPAN. I have been here before. (Laughter)

Senator DANFORTH. You know, just looking from the standpoint of how an investor would look at what his possibilities are, it is a little bit difficult for me to see why people would be particularly attracted to equity investments today. If the choice is high-yield debt versus low-yield equity and capital gains receive no favorable treatment, it does seem to me that we have tilted the system very heavily in the direction of debt financing.

The lack of a deduction for dividends paid is nothing new. The deduction for interest paid is nothing new. I mean, this has been the way the tax law has existed for a long, long time.

I remember when I was taking income taxation in law school, hearing all of the arguments about why we should have some sort of credit for dividends paid. We didn't; that was the way the system was. It seems to me that the one change that we have made—I don't want to go back and beat the dead horse of the 1986 Tax Bill, but what we did do in the 1986 Tax Bill is to remove the capital gains differential, and that, I think, was a very significant move, just two and a half years ago, away from equity financing toward debt financing.

Chairman GREENSPAN. I would agree with that, Senator.

The CHAIRMAN. Thank you very much.

The next question will be from Senator Daschle.

OPENING STATEMENT OF HON. TOM DASCHLE, A U.S. SENATOR FROM SOUTH DAKOTA

Senator DASCHLE. Thank you, Mr. Chairman.

Mr. Chairman, I sense I may be the only one on the committee, but I am still trying to get a better grasp of the impact all of this activity is having in our economy.

In answer to many of the fine questions that have already been asked you said, at one point, your only concern in this whole area is the level of subsidization. But then at another point you said, "the rise in debt is worrisome."

In your testimony you say that roughly two-fifths of the merger and acquisition activity has involved companies of cyclically-sensitive industries that are more likely to run into trouble in the event of a severe economic downturn, and I noticed your report—not that long ago, but some time ago—about the fact that LBO loans now comprise 9.9 percent of all commercial loan activity in large banks, a Fed report.

If we were in the middle of a recession right now, would your testimony have been the same as it was just now?

Chairman **Greenspan**. I certainly hope so, Senator.

Senator **Daschle**. I would think it would be. But what are the ramifications? Two-fifths doesn't sound like a lot, but it is 40 percent. These companies, apparently in your view, do not have the capacity to sustain an economic recession.

Chairman **Greenspan**. No, I wouldn't quite say that. I would say that they would have difficulties. Without going company-by-company and taking a look at the individual levels of leverage, I don't think we could realistically judge how sensitive each company would be to the maintenance of its fixed costs when it experienced a reduction in its cash flow.

Whem I said the only thing that concerned me about LBOs was the tax subsidy, I meant that with respect to the question of what types of legislative action would be appropriate. But I hope I made clear, the extent of the leverage involved is worrisome, in the sense that while one may say the restructuring is a plus, how it is financed is a different question and something which I find disturbing.

If, for example, all of this restructuring were done with equity, rather than leveraged buyouts I frankly would feel considerably more comfortable. It is the debt characteristics which I find bothersome.

Senator **Daschle**. If you had to report to the committee today that, instead of two-fifths, it were a half, or some greater figure than the two-fifths right now that you believe sensitive, cyclically, to the economy, would there be national economic consequences? Or are we still at a point where, from a national perspective we can absorb the impact of firms such as these having this cyclical sensitivity and not, in many cases, being able to survive?

Chairman **Greenspan**. In any significant recession, some of those firms would clearly be in trouble. I am not sure, short of going company-by-company, that one can make a useful evaluation about how significant it is.

I think, when one gets into the details of individual companies, there is an awareness among lenders, among the banks and the investment banking houses, of the importance of these cash flow and interest requirements, and that in most cases, the people who are lending the monies—and I hope this is true in the banking system, which I believe it is—are acutely aware of this question. And I would be hesitant to look at aggregate data and presume that we have a problem one way or the other.

In this particular instance, I think it only gives you sort of a rough order of magnitude of what the nature of the issues are. I merely put the two-fifths in because everyone has been making a very big issue of the fact that most LBOs are in cyclically nonsensitive industries—nondurable goods, and services, and the like—and that is factually true, but the number is not 90 percent.

Senator DASCHLE. Well, the impression I have from what you have just said is that, God forbid we find ourselves in a recession, this committee and the Congress certainly would be very surprised, and have a right to be surprised, that the aggregate data that you now have would be anything other than the fact that this data would not lead us to conclude that in a recession the economy would be very detrimentally affected by what has happened thus far.

Chairman GREENSPAN. Well, first of all, these are not data of the Federal Reserve; these are data that the various investment banking houses and the various other organizations have compiled and collect these numbers.

It is not possible to make a definitive judgment of how sensitive this problem is. My own impression is, we are not yet at a point of really serious concern.

The major concern that I have in this area is not what has happened in the past. I am concerned about projecting the types of changes which have been going on in recent years over the next four or five or six years.

If, however, this is a passing bulge in restructuring activity as a result of a one-shot change in the 1980s, then it is an issue which will go away by itself. I think it is something we ought to audit very closely, because one can't be sure that that is the case, and that is the reason why the central focus with respect to LBOs at the Federal Reserve rests on our supervisory function in the banking system. And hopefully, we will be able to make sure, as sure as one can, that the banking system is not unduly exposed to this phenomenon.

Senator DASCHLE. Thank you.

The CHAIRMAN. Thank you. Senator Chafee?

OPENING STATEMENT OF HON. JOHN H. CHAFEE, A U.S. SENATOR FROM RHODE ISLAND

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Greenspan, it seems to me what we are doing today and over these series of hearings are two things: One, we are trying to ascertain whether LBOs are bad—not just distasteful, but are they bad for the Nation. And secondly, if they are, what do we do about it.

I would like to refer to the second part. I understand your position on the first and your answer to the previous questioner, but I would like to refer to the answer that you gave to Senator Baucus in connection to the ramifications of eliminating the tax deductibility on this type of interest.

As I understand, your answer on the ramifications was that we just don't know what is going to happen if we should take that step. But one of them that we do worry about is that it would penalize Americans, as opposed to foreign corporations, should we take that route. Am I correct in that concern?

Chairman GREENSPAN. Yes, Senator.

Senator CHAFEE. So I agree with you that if there is a problem, we have to be very, very leery about the solution, and particularly this particular solution that some have suggested.

I would just like to ask you a little bit about corporate America, wearing your hat as an economist and as a member of these various boards:

It seems to me that, if you listen to the LBO professionals, they will say, "These corporations are badly managed; that is why we can pay 30 to 40 percent over the stock valuations of these corporations and how we can run them successfully. They are badly managed because the corporations are cozy little entities, in which they are primarily made up of friends of the chief executive officer, whom he has enticed on his board, and they are not out there to question him." That doesn't mean they are inside directors; they are outside directors. But they are friends, and they are not going to question the excessive use of corporate jets or all the perks that management has for themselves. They are not looking after the stockholder.

I believe that is a serious concern. Drawing upon your experience, could you help me on that? Am I worrying about something that doesn't exist? And if it does exist, what can we do about it?

One of my beliefs is we ought to have all members of boards of directors required to have a holding in the corporation. I don't mean 10 shares or 100 shares, I mean something substantial, and if they are not prepared to do it, force their directors' fees to go into the purchase of stock until they reach x-percent or x-amount. Does that make any sense?

Chairman GREENSPAN. Well, I think you are raising "the" key problem of corporate governance in this country. Under extreme stress, outside directors, irrespective of their association with the chief executive officer, have generally behaved the way they are supposed to behave. They do fully understand and respond to their corporate responsibilities, and they change from being a "club," as you put it, which merely is a CEO with a bunch of his friends, with the shareholders left out. I don't think that is the case when it really matters.

In the instances where I have been very closely involved, where major alterations in corporations have occurred and the chief executive officer's position was not acceptable to the outside directors, I have noticed innumerable cases where the CEO's views were changed or he was replaced. That does happen.

Senator CHAFEE. Usually, at that point, the directors are susceptible to lawsuits.

Chairman GREENSPAN. That is exactly what I was about to say next.

Senator CHAFEE. And that gets their attention.

Chairman GREENSPAN. Yes.

Senator CHAFEE. But previous to this, in the events that lead up to this, they are rather lackadaisical or chummy.

Chairman GREENSPAN. Well, when a corporation is running well and everything is functioning well, it is probably not altogether undesirable to have a quiescent board. I mean, there is no real advantage to have a board try to run a company it can't.

But the ability to get a greater independence of a board from the CEO is, I think, desirable if that can be done, and I am not sure how that can be. Perhaps the suggestion you make, Senator, is not a bad one. It does, however, eliminate the possibility of getting certain types of representations on the board of people who can't afford, personally, to hold large stakes. But there is no question, when you have a board which has very large shareholdings, attendance is higher, their interest is higher, and the chief executive officer tends to listen with a great deal more awareness of what is being said to him than is often the case.

Senator CHAFEE. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Chairman, we are most appreciative of your being here. I think it has been productive and helpful to us. Thank you very much for your attendance.

Chairman GREENSPAN. Thank you very much, sir.

The CHAIRMAN. Our next witness will be Mr. Lane Kirkland, Chairman of the AFL-CIO, Washington, DC

We are very pleased to have you, Mr. Kirkland.

Let me state to the Members, we have a number of very able and interesting witnesses that are still left to testify. I am going to put a limitation on time. The witnesses are to understand that we will have a five-minute limitation so that we can have time to question them on their presentation. We will take their entire statement for the record; Members will be limited to four minutes in their questioning.

Mr. Kirkland, we are very pleased to have you.

STATEMENT OF LANE KIRKLAND, CHAIRMAN, AFL-CIO; WASHINGTON, DC ACCOMPANIED BY ROBERT McGLOTTEN, DIRECTOR, DEPARTMENT OF LEGISLATION, AFL-CIO; AND RUDY OSWALD, DIRECTOR, DEPARTMENT OF ECONOMIC RESEARCH, AFL-CIO

Mr. KIRKLAND. Thank you, Mr. Chairman.

With the permission of the Chair, I would like to present just a summary of my full statement which I have submitted to the committee.

The CHAIRMAN. Without objection, that will be done.

Mr. KIRKLAND. Mr. Chairman, Members of the Committee, thank you for conducting this hearing and affording me the opportunity to testify on the subject of leveraged buyouts. We look forward to working with you and members of the Labor Committee and other appropriate committees in the coming weeks as we search for legislative solutions to this crucial financial issue.

It is altogether fitting that, at the outset of the Hundred and First Congress, this process begins here in the Finance Committee with an examination of the tax laws. In our view, that is where you will find the root of the problem.

The AFL-CIO takes a dim view of Wall Street's current fascination with the leveraged buyout. We see great energy and vast resources being committed to an internecine struggle among the nation's corporate elite, one yielding no expansion whatsoever in America's capacity to produce goods and services or in its competitive strength.

While corporate America incurs billions upon billions of dollars of new debt, not one new product is made, not one new service is marketed, not one factory is built, and not one job is created.

We know who the winners are in this high-stakes game: the speculators who initiate these deals and make quick-and-easy megaprofits, not necessarily by prevailing in their takeover efforts but just by playing the leveraged-buyout game, and they are the investment bankers and lawyers who pocket fat fees, millions of dollars per deal.

Who loses? We know all to well, I am afraid. When corporate assets are sold off to meet this unprecedented level of new corporate debt, when subsidiaries and divisions are sold off, when factories are shut down, stores and offices closed, wages and benefits reduced, pension money used to pay greenmail, it is the working Americans who pay the price with the loss of their livelihoods and the debasement of their communities.

We estimate that the long list of mergers, takeovers, and leveraged buyouts over the past decade has directly resulted in some 90,000 of our members losing their jobs. Many thousands more have been forced to take wage and benefit reductions as the result of corporate restructuring in the face of massive new debt. It is difficult not to be skeptical or even downright cynical in reaction to the feeble attempts to justify this latest craze.

A few years ago, when large companies were gobbling each other up, we were told that bigger is better, that conglomeration helped corporations become stronger and more efficient to compete in the world economy. Now that takeovers are largely finance driven, and corporate disintegration through leveraged buyouts are all the rate, we are told that companies are more efficient when broken up and their assets are sold off piecemeal.

One thing we know for sure, while the rest of the industrial world soberly invests in the future, our financial elite, with the complicity of major banks, brokerage firms, investment houses, prestigious law firms, and the best and the brightest graduates of our leading universities and business schools, is engaged in a drunken, short-term revel. Whether or not we crash and burn is not the question, only when and how many casualties there will be.

The AFL-CIO takes no pleasure in this prediction. We know the ultimate price will not be paid by the dealmakers—they will take the money and run—rather, it is the working people of America, those whose voices cannot now be heard above the din on Wall Street, who will suffer.

Despite what we believe to be the strong sentiment of the American people, that the proliferation of leveraged buyouts is not in the public interest, our government, through the Tax Code, is subsidizing and therefore encouraging these questionable deals.

The law favors the financing of corporate activities through debt rather than equity. We tax debt as much as 87.5 percent lower than equity, as though this were good public policy. It has become clear under present circumstances that it is not.

This preferential treatment of debt has wrought a vast increase in corporate indebtedness, a shrinking of the tax base by as much as $50 billion, and the switch from productive investment to speculative paper transactions that has added a serious new element of risk and vulnerability to an already shaky and fragile economic situation.

Consistent with the notion that the tax laws should safeguard the public interest, we suggest that the Committee and the Congress move to correct this situation by adjusting the Code to disallow the corporate interest deduction for debt to finance an LBO, a takeover, or the requirement of equity.

While I am no tax expert, you don't have to tell me that this won't be the easiest thing in the world to do. I understand that you will have to carefully craft the definition and create tracing rules to prevent debt recharacterization and to assure that the spirit of the law is observed. I am sure, however, that this committee has the technical skills to devise a workable approach.

I also see no philosophical barrier. This committee and the Congress has previously held that all interest payments are not sacrosanct. You have found the necessity and the means to make certain discriminations on the deductibility of interest for individual filers; there is no reason why the same approach should not be applied to corporate returns.

The only other solution that has been mentioned—that is, a new corporate deduction for dividend payments—makes no sense, for a variety of reasons, and particularly under the current budgetary circumstances. The Treasury simply cannot afford the revenue hemorrhage.

AFL-CIO has other important concerns about leveraged buyouts, such as the laws which enable prevailing companies in hostile takeovers to terminate established bargaining relationships and to cancel collective agreements in force.

In addition, current law has enabled employers to take $18.7 billion in pension money this decade from nearly two million American workers through pension fund terminations and reversions related to mergers, takeovers, and leveraged buyouts.

We want to change these laws to protect workers, and we will pursue this agenda in the Congress before the proper committees.

Mr. Chairman, workers have a vested interest in the long-term stability of the corporations which employ them. They and their families are inextricably linked to the continuing production of goods and services on their native soil and in their home towns.

We in the labor movement want to be able to negotiate in good faith across the table with thriving private companies managed by substantial people who create and sell useful things.

The leveraged-buyout mania is working to the detriment of these interests as well as to the economic future of this Nation. It must be dealt a terminating blow, and we ask that you give serious consideration to our suggestion aimed at accomplishing this.

That completes my testimony, Mr. Chairman. I will be happy to answer any questions you and the committee members might have.

[The prepared statement of Mr. Kirkland appears in the appendix.]

The **Chairman**. Well, Mr. Kirkland, we are very happy to have you before us. You have a long record of working for and defending the working men and women of America, and I agree with your observation that corporate restructuring can have some very substantial costs for individual working men and women in the way of lost income and jobs and anxiety.

You talk about workers' protections. You refer to that in your testimony. What are you specifically referring to?

Mr. **Kirkland**. There are several aspects of it, Senator. One that deeply concerns us, of course, is the experience that we have had where these takeovers have taken place, and the new management has nullified and refused to recognize the existing collective agreements that were entered to following the certification of a union and the expression of the workers' choice to be represented by a union. We believe that there should be legal moves that assure that those agreements will be recognized, successorship provisions to that effect.

We are also concerned with the way in which many managements have played fast and loose with pension funds that, in our view, properly belong to the employees of the establishment. Pension plans represent wages deferred or concessions made through the bargaining process. We oppose the extraction from those funds of what at the moment appear to be "overfunding" rather than using that favorable experience of the pension fund to enhance benefits. The result is the termination of plans and their substitution with arrangements which do not provide the prospects of the previously-agreed benefits.

And of course, the extent to which pension fund managers in some cases, propelled by the desire to show extraordinary performance, have been players in this takeover game. We do not think that these junk bonds are appropriate investments for pension funds.

The **Chairman**. Thank you. Senator Packwood?

Senator **Packwood**. Lane, could you check one thing for me? I don't know if you were here when I made reference to the takeover in Oregon of the Fred Meyer chain. That is principally a food store, also dry goods. It is unionized. It was United Food and Commercial Workers, and probably some Teamsters in the warehouse, would be my guess.

Mr. **Kirkland**. Yes.

Senator **Packwood**. They were, years go, a multi-employer bargaining unit; so, if they stayed that, they would have had a hard time, I think, getting an agreement out of the union to cut the benefits in their stores and not others because of the bargaining unit.

Could you check and see, did they drop out of the bargaining unit? They are still unionized. Have there been give-backs? There are about 4,000 more jobs than at the time of the LBO, and I am just curious about what has happened on employment, union employment, give backs, are they still in the multi-employer bargaining unit, or what.

Mr. KIRKLAND. We will be glad to check that, Senator.

Senator PACKWOOD. Thank you, I appreciate it very much.

Mr. KIRKLAND. Yes.

Senator PACKWOOD. Thank you, Mr. Chairman.

Now, who is it? Senator Danforth.

Senator DANFORTH. Well, we have taken control. (Laughter)

Senator PACKWOOD. Quick, Danforth, you have got three minutes.

Senator DANFORTH. To repeal the 1986 Tax Act. (Laughter)

Senator PACKWOOD. Well, that is how fast we passed it.

Senator DANFORTH. Mr. Kirkland, your concern is about jobs, and I have been given a report by the Kohlberg Kravis Roberts firm on leveraged buyouts. They say in their report, with respect to employment, and I am quoting:

"The total number of employees in KKR companies has increased from 276,000 in the LBO year to 313,000 three years after the LBOs. The average annual rate of growth has increased from 2.3 percent before the LBOs to 4.2 percent after the LBOs." In other words, what they mean by "growth"is growth in numbers of employees.

Are you confident that leveraged buyouts means less jobs?

Mr. KIRKLAND. That has been our experience, sir, on a case-by-case basis, and I think the specifics are attached in our formal statement of what has happened following these episodes. I have not seen the document that you are quoting. It would seem to me that the authors of it are players in the game, and I would want to examine it very carefully.

Senator DANFORTH. Well, they are, but I don't have any reason to doubt the factual statement they make.

Mr. KIRKLAND. I have neither any reason to doubt it nor any reason to trust it, sir. (Laughter)

Senator DANFORTH. Well, I think that this is something that deserves attention, because, I mean, you have asserted that there is a reduction in employees, and they have asserted that from the standpoint of their LBOs—and they are said to be the leader in the business—their companies have gone from a 2.3 to a 4.2 growth rate in employment after the LBOs.

Mr. KIRKLAND. As I say, I have not seen it, sir. I have not had an opportunity to examine it. We will be glad to do that and give you our comments on it.

Senator DANFORTH. Thank you.

The CHAIRMAN. Senator Chafee?

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Kirkland, I share your deep concern and distaste for these leveraged buyouts, and what you said about the grotesque profits that are being made by a whole series of people down the line who take their money and leave.

I don't know whether you were able to be here earlier, but if there is a problem, and some question whether there is a problem, what do we do about it? That is where we get into heavy weather.

The Chairman of the Federal Reserve pointed out a whole series of misgivings about the cure, or proposed cures—I just wanted to share that with you—one of them being his last statement in the questions I was asking him in connection with disallowing the deductibility of the interest for this type of activity.

Let's assume you can pinpoint what is a leveraged buyout, what is a bad leveraged buyout, and the interest attributable thereto. Then we get into the problem. All right? We disallow it under the Internal Revenue Code. Some foreigner then can come in—and you have mentioned frequently in your statistics here Sir James Goldsmith and the wreckage he has left behind.

So that is our difficulty here as we face this, that we are heading into unchartered waters, not knowing that the cure attempted might be worse than the illness that exists.

As I understood your testimony, that was the principal solution you had. You also had facts about the pensions and so forth.

Mr. KIRKLAND. As far as the Tax Code is concerned, yes, sir.

Senator CHAFEE. Yes.

I must say I don't know why we can't end this greenmail. That is one of the most objectionable areas, where these people come in, make a run on a corporation, aren't serious about getting it but get enough to scare the dickens out of the company, and then get paid off. They are in the world's best position—no responsibility, they don't own the thing. At least KKR ends up with a substantial investment in these corporations, and in many instances an equity investment. But that isn't true of the Hafts and the others who are so skillful at getting this greenmail. I don't know why we can't do something about that.

That really is a statement more than a question, Mr. Chairman.

Mr. KIRKLAND. I am conscious, sir, of the issue of the matter of possible enhancement of the advantage that foreign investors now enjoy under the present tax law. That exists now. And I do believe, if this step is taken that we would advocate, that it ought to be made a feature, a covenant of tax treaties which govern those activities by foreign investors. Those tax treaties now, as I understand them, do give investors from many countries a relative economic advantage over domestic investors.

Senator CHAFEE. Okay. Thank you.

Mr. KIRKLAND. The question of greenmail? I agree completely with you, sir. There are other aspects of the case that is made by the advocates and agents of these buyouts. I keep seeing the proposition that it is needed, that it invigorates American enterprise by shaking up entrenched management, complacent management.

Now, I am no defender of American management. In any litany of its faults I could add a few that stem from our experience.

I would acknowledge that Ancient Rome was perhaps decadent, but I do not believe that its future prospects were improved by the restructuring brought about by the Vandals and the Ostrogoths and the Visagoths.

The CHAIRMAN. That is a pretty profound statement. (Laughter)

Mr. Kirkland, we are delighted to have you, and we appreciate it. Thank you, Lane, for coming.

Mr. KIRKLAND. Thank you, Mr. Chairman.

The CHAIRMAN. We are going to continue here for a while and see how far we can get along in giving each of these witnesses a chance to testify.

Our next panel will be that made up of John J. Creedon, who is the President and Chief Executive of Metropolitan Life Insurance Company; and Mr. Bruce Smart, the former Chairman and Chief Executive of the Continental Group and former Undersecretary of Commerce.

Gentlemen, we are very pleased to have you, and perhaps for a presentation of a differing viewpoint.

STATEMENT OF JOHN J. CREEDON, PRESIDENT AND CHIEF EXECUTIVE OFFICER, METROPOLITAN LIFE INSURANCE COMPANY; WASHINGTON, DC

Mr. CREEDON. Mr. Chairman, thank you. I am very pleased to be here.

As you know, Metropolitan Life is a mutual life insurance company which provides insurance coverage and other benefits to over 42 million people in the United States and Canada. We have historically provided long-term fixed-rate capital to industry, and one of the reasons we are here today is because we believe that the ability of long-term investors to continue to fulfill that critical function is being seriously threatened by certain developments in the financial markets.

Our total investment portfolio under management currently exceeds $115 billion, of which about $75 billion is comprised of long-term bonds and mortgages on real estate. In 1988 alone, our gross new long-term investments totalled almost $20 billion.

As a company, we have always emphasized quality in our investment activities, as attested to by our consistent portfolio ranking at the very top of the insurance industry, our AAA rating with both Moody's and Standard and Poor's.

Thus, Met Life and its policyholders have a very considerable stake in the continued health and vitality of the U.S. economy and its capital markets, in particular.

I am going to depart, if I may, from the prepared statement and just talk a little bit about what I think the main issues are.

First, as has been indicated, we have a concern about the level of corporate debt in the United States today, and especially the excessive debt in the case of some corporations.

We are also concerned that the junk bonds that have been created through the leveraged buyouts are being held by institutions, various institutions. Mr. Greenspan indicated a concern about the banking industry; I have some concern about the insurance industry and some other institutions that have invested in junk bonds, and the concern has to be if there is a serious economic downturn, and whether the institutions that have assumed all this leveraged debt will be able to pay the debt.

Many comments have been made about the fact that so far the leveraged buyouts have done very well. But most of them have occurred since 1982, and we have not had a serious economic downturn while most of them have been around.

In some ways, junk bonds are more like equity than like debt; but the statutory limitations applicable to institutions, for example life insurance companies, they might limit the amount of equity that can be invested in to a certain percentage of the portfolio. But it doesn't include junk bonds because, by definition, they are debt. So, in a way, some of the statutory limitations applicable to institutions are being circumvented.

If you looked at junk bonds as equity, perhaps banks shouldn't invest in them at all, because they are not generally permitted to invest in equity.

Now, the case of the insurance industry in New York, the Superintendent of Insurance has regulated that no life insurance company can invest more than 20 percent of its assets in junk bonds; so, there is an effort being made to say, from a regulatory standpoint, something should be done.

I think one of the other concerns is that many of the LBOs and restructurings seem primarily to be financial manipulations—now, we are not against LBOs. we have invested in some of them, have made favorable investments, and have been very satisfied; but some of them are primarily financial manipulations that do not have a sound economic productivity-improving objective—and clearly whether the tax laws should encourage that kind of manipulation.

Another concern is that, in some LBOs, the transactions are designed to increase the wealth of the stockholders and of course those who do the manipulations, but other constituents of the corporation are ignored. By "other constituents" I include the creditors and the employees and the community.

In the case of the creditors, in one transaction, in RJR Nabisco, $5 billion of bonds, on the day the LBO proposal made by management was announced, was reduced to $4 billion. So it was a $1 billion loss in the value of the bonds in one day.

What to do? First, we believe that it should be made clear that all constituents of a corporation need to be considered. The Williams Act might be amended to require disclosure of the effect of the proposed LBO on employees, on creditors, and others. ERISA might be amended to make clear that pension fund managers should consider the rights of others than the stockholders—the employees and the creditors—and some States are doing that.

From a regulatory standpoint, junk bonds might be considered as equity, for purposes of limitations of investments by insurance companies and others.

While Mr. Greenspan did not seem to be concerned about insurance companies, I do have a concern about insurance companies. One of the concerns is that under the laws of many States, if an insurance company becomes insolvent, the solvent companies then have to make up for the insolvency, and Baldwin United was a good example of that a few years ago.

Finally, for purposes of the Federal income tax, the subject of this committee, that the treatment of junk bonds in LBOs and summary structure certainly should be reevaluated from the standpoint of interest deductibility—I am not sure. I don't know what should be done. It is possible to do it prospectively, perhaps, with respect to a transaction with a certain proportion of debt when the purpose is a takeover or major restructuring.

That is my testimony, Senator.

[The prepared statement of Mr. Creedon appears in the appendix.]

The CHAIRMAN. Mr. Creedon, your company took a very substantial loss on its investment in the RJR Nabisco bonds, as I understand it.

Mr. CREEDON. Yes, sir.

The CHAIRMAN. It has been argued to me by some that this is a self-correcting problem, and that bondholders would put poisoned puts into the debt agreement to try to protect themselves against that kind of a loss in the future. How would you respond to that?

Mr. CREEDON. I think to some extent the investment banking community is beginning to look at different types of provisions that might be put in public debt issues to solve the problem. So far, we have not seen any that we thought dealt with the problem adequately.

Part of the concern is with respect to all of the public debt that is already outstanding, which runs the risk of being converted into junk.

As you know, we have started a lawsuit against RJR Nabisco, and our position is that it was not proper to structure refinancing that did not take into account the position of the public creditors.

The CHAIRMAN. Well, in pursuing that one, your case in litigation, if it is appropriate, are you contending that a State law or a Federal law is violated in this instance?

Mr. CREEDON. State law, yes, sir. We are contending that there was an implied covenant of fair dealing and that, when a company borrows money from the public, one of the implied representations is that it will not do a specific act that will destroy that credit, which is what happened in the case of RJR Nabisco.

The CHAIRMAN. Does your company invest, at times, in things that might be considered below investment grade?

Mr. CREEDON. We normally invest in investment grade. We have invested in some LBOs with KKR, for example, and when we do make an investment of that kind we really view it as an equity-type investment. We are permitted to make equity-type investments, and we would view that as that type of investment.

The CHAIRMAN. Senator Packwood?

Senator PACKWOOD. John, you said one thing that I didn't know: if insurance companies go belly up, the other insurance companies have to pony up enough money to pay off—who?

Mr. CREEDON. The policyholders.

Senator PACKWOOD. The policyholders?

Mr. CREEDON. Right. That is the law in a majority of the States.

Senator PACKWOOD. Do you mean it would be as if we were to require the good S&Ls to pony up to pay off for the bad S&Ls?

Mr. CREEDON. Yes, sir.

Senator PACKWOOD. Does that work out pretty well for theinsurance companies? I mean, do you like that system? (Laughter)

Mr. CREEDON. Well, you know, there are a certain number of insolvencies each year, and a company like Metropolitan does, to use your expression, "pony up some money" for the insolvent ones. Yes, sir.

But that is part of the concern, because, when Superintendent Corcoran in New York changed the law or regulated that, a company could not hold more than 20 percent junk bonds. It reflected a concern on his part that some companies were acquiring too many junk bonds. And indeed, outside of New York there are a few companies that had over 50 percent of their investments in junk bonds.

Senator PACKWOOD. Would you do me a favor? Because I am struck by this bail-out. Could you have your staff send me a list of the States where that is required, and where the solvent companies are required to bail out the insolvent companies?

Mr. CREEDON. Yes, sir, I shall be glad to do it.

Senator PACKWOOD. Thank you. I appreciate it. That may be a good precedent. (Laughter)

[The list of the States mentioned above appears in the appendix.]

The CHAIRMAN. Senator Chafee, I really ought to get Mr. Smart into this act; so, why don't you give us your testimony, and then we will go on with the questions, so we can question the two of you? I apologize, John.

Mr. SMART. All right, sir.

STATEMENT OF BRUCE SMART, FORMER CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CONTINENTAL GROUP, AND FORMER UNDERSECRETARY OF COMMERCE FOR INTERNATIONAL TRADE

Mr. SMART. As my testimony has been submitted, I will try to summarize it briefly. As it indicated, before I was in the government, I was the chief executive of a company called The Continental Group, previously Continental Can Company, a diversified international Fortune 100 company with businesses in 10 different countries in the fields of packaging, forest products, insurance, and energy.

When I became CEO in 1980, I felt that the company had become too loose and too diversified, and we started a restructuring program which by 1984 had sold off about a quarter of the company, redeployed the assets into our better businesses, and tightened up the structure.

Unfortunately, that activity caught the attention of Sir James Goldsmith, and he made a tender offer, or threatened a tender offer—our stock then being at about $35, having gone up from about $20 when I became CEO. He nevertheless felt $50 was appropriate if he could have the opportunity of concluding the restructuring which we had started.

There seemed to be no sensible, responsible way using the various defensive ploys to resist Sir James, because he was offering all cash for all the shares, and we were fiduciaries for the shareholders. So, eventually the company was auctioned off and bought by another group of investors at 67 percent, ($58.50) over the preattack price.

From those experiences and seeing what happened to the company under the highly-leveraged situation that occurred as soon as it was taken over, I have come to some very strong conclusions as to what these activities do to companies, to the way they are managed, and to their capability of competing in world markets.

I see two classes of harm being generated here. And, admittedly, there are also probably some offsetting benefits.

One class of harm is "local" or "micro". It involves the unfairness to the other stakeholders in the company when only the common shareholders are considered. Most of those have been mentioned by previous witnesses. Obviously, bondholders and preference shareholders, when a company is highly leveraged, lose the investment quality that they had presumed when they bought shares or bonds or loaned the money, and they have been hurt. At their expense, the common shareholders were rewarded.

Employees who cast their long-term lot with the company do so in part for future potential benefits: promotional opportunities, professional growth, and secure retirement. They, too, if they become redundant or if the company becomes less financially strong and unable to move forward, are hurt.

And then, finally, customers, suppliers, and other contractors, not to mention host communities, have committed to a company with one type of management and one type of financial structure and now are dealing with what, I believe in many cases, is a less reliable and less responsible party on the other side of the relationship.

The "macro" effects are also very important. The first is management's concentration on the short term. We were in a yield-type of security because of the mature nature of our basic original business, the can business.

To improve the value of a yield security, you must increase reported earnings. You can do so, obviously, by responsible management action, but you can also do so by a large number of financial manipulations such as expensing costs versus capitalization, longer asset lives, less conservative accounting, and selling off, of course, your more promising businesses that are not yet ripe, using the proceeds to do things that give you earnings more quickly. And of course, finally, you can cut your R&D.

A second "macro" concern is the effect of leveraged takeovers on the economy at large. This has been gone into at great length this morning and I won't go further, except to say I support everything that has been said in that respect.

But there is one aspect of the long term that has not been mentioned, and that is the effect of these trends on young people. We see too many of our brightest young people, lured in part by the financial rewards of careers in law and investment banking that the takeover binge has made possible, going in that direction rather than into corporate management, into engineering, or marketing, or manufacturing, where we need them badly to compete internationally. So that bothers me.

I have three general sets of recommendations.

The first: I would suggest consideration of what I would call a "stakeholders' bill of rights," which would in some way require the successor company to make whole those stakeholders who are not common shareholders for the damages that they sustain. Bondholders would be one such category of shareholder, employees another. Employees need severance agreements, protection of pensions, health insurance in retirement, etc. Other shareholders are contractors and host communities.

Second, I would consider using the tax and security laws to give equal tax treatment to dividends and interest. That has been gone into heavily here. Perhaps we should regulate the investment risk allowed federally-guaranteed institutions, and consider reimposing a differential tax on long-term capital gains compared to short term, because obviously the arbitrageurs are a part of this play.

A third possibilty would be to modify the process, and I have two particular thoughts there:

When we were attacked, the 20-day "window" before which Sir James could buy the shares he planned to tender for was a tremendous impediment to us in searching for other and presumably better options, other people who might come in and make a more appropriate offer for the company than he did, and that 20 day window is far too short.

And then, secondly, I think that greenmail—which we were not threatened with, incidentally—is something that really should in some way be outlawed; it is just not proper to offer one shareholder preferred terms that you are not willing to offer all shareholders.

Thank you, sir.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Smart appears in the appendix.]

The CHAIRMAN. Senator Chafee?

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Smart, how long should the window be?

Mr. SMART. I have heard all sorts of discussions, Senator, from 60 days to 6 months. In our case, I think 60 to 90 days would have been adequate for us to develop the options and present them to the board for their decision.

Senator CHAFEE. Is there any difference between the window length for an insider bid and an outsider bid? Management making a bid, for example? Is it the same length of time?

Mr. SMART. I have to say that a year before Sir James appeared, I went over in my own mind the fact that I believed our company would be better served by being taken private, and how could I and a management group do that? I discussed it with two of my directors, and I found no way that an existing management, in my opinion, could ethically make an LBO offer for its own company without finding itself on both sides of the transaction. So, we concluded—I and my two directors—that it was not fiduciarily responsible for us to consider that.

So, in that context, I really don't like self-initiated insider LBOs. I don't mind insider LBOs once the company is, if you will call it, "in play." I don't want to judge others, but that was the decision that I reached. So, it is hard for me to answer your question. But, clearly, management knows a great deal more about the strengths and weaknesses of the company than any outside bidder and is, in that sense, in an advantaged position to know exactly what can be done.

Senator CHAFEE. Did I understand that if an outsider started the play, you then believe it would be ethical for the insiders to get together and come up with a counter-offer?

Mr. SMART. Yes, sir, and we considered that in our case and determined that we could not match the bids of the outsiders.

Senator CHAFEE. I agree with your concerns, and this is a poignant statement that you have made here, about what happened to a company you knew a lot about. However, I must say, on page 11 where you talk about the shared ownership, and where there must be compensation for "damages" to customers and suppliers, no one will argue with the concern; but attempting to effect that, it seems to me, would be extraordinarily difficult.

Mr. **Smart**. Well, let me give you an example, Senator. In our business we negotiated long-term contracts with the users of beverage cans and beer cans to install plants adjacent to or even on their premises, to in effect marry the can plant to the brewery or the soft drink filling operation. Those contracts were entered into by major producers of those products based on our reputation for being a leader in R&D, for high quality and reliable service. The availability of high quality containers was essential to their delivering a quality product to the marketplace.

When our company was taken over, and I cannot tell you what happened afterwards but clearly there was not under the leveraged conditions as much money to support R&D or perhaps even the same concern for quality and for disregarding bad product—I can't say this is the case, but the pressures would be there—that these customers had come to expect in dealing with the prior, well-financed, and carefully managed company.

It seems to me there should be an opportunity for contractors of that sort to say to the new management, "We want to renegotiate the contract. We want to take a look at you," and to have ultimately the right to abrogate the contract if they aren't satisfied with what they find.

Senator **Chafee**. Okay. I have no other questions. Thank you.

Thank you, Mr. Chairman.

The **Chairman**. Senator Packwood?

Senator **Packwood**. No further questions, Mr. Chairman.

The **Chairman**. Gentlemen, that has been very helpful. I appreciate that. Thank you very much for coming.

Mr. **Smart**. Thank you.

Mr. **Creedon**. Thank you, Senator.

The **Chairman**. Our next witness will be Dr. Kathleen Utgoff, who is the Executive Director of the Pension Benefit Guaranty Corporation; Washington, DC

Dr. Utgoff, we are very pleased to have you.

STATEMENT OF DR. KATHLEEN P. UTGOFF, EXECUTIVE DIRECTOR, PENSION BENEFIT GUARANTY CORPORATION; WASHINGTON, DC

Dr. **Utgoff**. Thank you, Mr. Chairman.

I have a longer, written statement which I would like submitted for the record. Let me make a few oral remarks.

The **Chairman**. It will be put in in its entirety.

Dr. **Utgoff**. I am delighted to be here, especially because this is the first time that I have been able to appear before you and not have to discuss the imminent financial collapse of the PPGC.

Because of the changes in law under the Pension Protection Act—

The **Chairman**. If it wasn't for the limitation in time, I would get back to that, but go ahead.

Dr. **Utgoff**. —which this committee was instrumental in passing, the PPGC is in much better financial condition than it was just a few years ago.

The PPGC insures defined-benefit pension plans, and it is these pension plans that have become involved in the controversy over mergers, acquisitions, and the debt structure of corporations. The enormous amount of capital invested in pension funds and the involvement of defined-benefit pension plans in LBOs has led to several concerns.

One of those concerns is over pensions as owners of assets that are involved in takeover activity. Pension plans own stocks and bonds of takeover targets. They invest in LBO funds as well as high-risk bonds that may or may not be related to takeovers.

These LBO investments in high-risk bonds, as part of a prudently-managed diversified portfolio, do not represent risks to workers, retirees, or the PPGC. Under current law, pension funds may include other investments that carry higher levels of risks than takeover-related investments, such as venture capital and real estate. Only a very small percentage of total pension assets are invested in the bonds and LBO funds that are being discussed here today.

LBOs would go on without pension—

The CHAIRMAN. Would you state that, again? I want to be sure I heard that. Only what, now?

Dr. UTGOFF. Only a very small percentage of total pension assets are invested in the bonds and LBO funds that are being discussed here today, and I mean very, very small.

The CHAIRMAN. All right.

Dr. UTGOFF. LBOs would go on without pension capital and, on net-pension plans, as investors, probably benefit from the greater returns and increased stock values that result from LBOs.

The second issue was whether the surplus pension assets play a role in takeovers. When LBOs and surplus assets were a relatively new phenomenon, there were instances where surplus assets may have played a role in takeovers. I believe that the value of surplus assets is now reflected in the stock price of the company when it is a takeover target.

In effect, the purchasers of companies with over-funded plans pay for the surplus assets. As long as stock prices fully reflect pension assets, surplus pension assets cannot cause LBOs.

The evidence suggests that surplus pension assets are not a significant cause of or a source of capital for LBO activity. The PPGC reviewed all reversions greater than $100 million. In only two of the 30 cases in this category was the company involved in an LBO. An additional four of the 30 were involved in a takeover.

These results are generally consistent with other studies, and some of those studies are described in my written testimony.

Although the direct role of pensions in financing LBOs has received a great deal of attention, I am more concerned with a third issue, which is the effect of LBOs on companies that sponsor pension plans.

Pension plans do not fail because of the investments they hold; they fail because the companies that sponsor them run into trouble. Financial distress can mean reduced funding of the pension plans and bankruptcy. These are the conditions that jeopardize pension security and the PPGC.

If highly-leveraged companies are more likely to fail, then the PPGC will be asked to step in more frequently as LBOs increase.

The cost to the insurance program of those failures will depend on the funding of the pension plans and how much of the underfunding the PPGC can recover as a creditor in bankruptcy. Companies with high debt costs are more likely to cut back to minimum funding levels, and they are more likely to apply for waivers of pension contributions.

In addition, the distribution of assets to the shareholders in an LBO reduces the assets available to the PPGC, as an unsecured creditor, in the event of a bankruptcy.

The net result of these two effects is that, even if LBOs do not increase the probability that a company may fail, each failure, when there has been an LBO, will be more expensive for the PPGC.

My written testimony describes a case of the PPGC which illustrates our concerns over this issue. It is the Kaiser Case.

Kaiser Steel was involved in an LBO in 1984. Nearly $200 million was distributed to shareholders and other parties involved in that restructuring. In 1987, Kaiser filed for bankruptcy, and the PPGC lost $200 million, and retirees lost health care insurance worth several hundred million dollars.

Kaiser is a good example of the complexities of this problem. The difficulties of the steel industry are well known, and the PPGC may have been forced to pay for Kaiser's pensions in any event; but, whether or not that is the case, the assets available to cover the pension underfunding would have been greater without the LBO.

The effect of the Kaiser LBO was to reorder the priority of different claims against Kaiser's assets. Shareholders—and they are usually the lowest priority creditor in a bankruptcy—profited as they often do in an LBO. The distribution of cash to shareholders reduced the assets available to satisfy the claims of other creditors.

The effect of an LBO on the rights of different claimants has been the source of complaints from holders of bonds that were issued before the LBO. You have heard some of them today. Bondholders are now beginning to put covenants in their agreements to protect their rights, and that is a normal market response, but the PPGC and retirees do not have those same opportunities.

Let me make it clear that my concerns about the possible effects of LBOs on the government pension insurance system are not a criticism of LBOs. There is evidence to support the belief that LBOs increase the efficiency and value of a company and that pension plans can benefit from that increase in value. But every party with a stake in a firm does not share equally in the risks and benefits of LBOs.

The PPGC and other unsecured creditors may take risks without proportionate shares in the gains. This does not mean that LBOs have to be restricted to protect retiree benefits.

We can explore other solutions to make sure that the legitimate rights of all parties that have a stake in a firm are not jeopardized by new and perhaps very useful corporate financing techniques.

Thank you. I would be very happy to answer your questions.

[The prepared statement of Dr. Utgoff appears in the appendix.]

The Chairman. Well, that statement is interesting, because I had read some published reports that pension funds and tax-exempt funds had been substantially involved in LBOs. But insofar as pension funds, you say it is minimal.

Dr. UTGOFF. Let me make a couple of issues clear here. There is the excess-assets issue. All right? Clearly, excess assets do not play a substantial role, just simply because of the amount of money that is involved.

Mr. Kirkland talked about $18 billion being removed from pension plans.

The CHAIRMAN. I am not talking about that. I am talking about the investment of the pension funds themselves in LBO transactions.

Dr. UTGOFF. Yes.

The CHAIRMAN. And you are telling me, very definitely, that you think that is minimal. Is that correct?

Dr. UTGOFF. Yes. Only about 1 percent of total pension plan assets consist of what you would call "junk" or below investment-grade bonds. And if you look at the pension plans that own those kinds of things, it only consists of about 5 percent. So there is really a very small amount; although, that amount of money can be a large number, it is a small total amount of money relative to the total amount of money that is invested in pensions.

The CHAIRMAN. All right. Now, in the claims against PPGC, do you see any correlation with heavily-leveraged companies getting into trouble and those claims?

Dr. UTGOFF. Yes. All the companies that we deal with are highly leveraged. That is because they are in deep trouble, and companies in deep trouble will do anything they can before the end. So I think it is very important here—that doesn't mean that every highly-leveraged company will come to us, it just means that the companies we deal with are highly leveraged.

The CHAIRMAN. By the time they get to you, they have resorted to every form of debt they can get a hold of to keep operating, is that it?

Dr. UTGOFF. Right.

I think it is important to distinguish between what I would call the "voluntary debt," that is done to improve the stock value of a company or for tax purposes, and "involuntary debt," that you take on just to get through the next month. That is a very important point when we are looking at LBOs and how leverage may affect PBGL's claims.

Another important point that has been alluded to by several other people that have talked to you has been just how those LBO bondholders behave. Do they behave as equity holders or as bondholders? How will they behave when the company gets into a crunch? That will make a very big difference on just how LBOs will affect us.

The CHAIRMAN. Thank you.

Senator Packwood?

Senator PACKWOOD. No questions. Good testimony.

The CHAIRMAN. Thank you.

Dr. UTGOFF. Thank you.

The CHAIRMAN. Thank you very much. And we still haven't shot the messenger. We have had you before us many times, and I think that we have made some real progress.

Dr. UTGOFF. Thank you. I believe we have.

The CHAIRMAN. Mr. Steven Kaplan, who is Assistant Professor of Finance, Graduate School of Business, University of Chicago.

We are pleased to have you, sir.

STATEMENT OF STEVEN N. KAPLAN, ASSISTANT PROFESSOR OF FINANCE, GRADUATE SCHOOL OF BUSINESS, UNIVERSITY OF CHICAGO; CHICAGO, IL

Mr. KAPLAN. Thank you, and thank you for inviting me to express my views.

The RJR Nabisco leveraged buyout has focused America's attention on buyouts and the general effects of corporate leverage; and, as this committee meeting suggests, there has been a tremendous amount of controversy concerning where the profits in buyouts come from.

The evidence from my work supports the view that management buyouts create more efficiently-operated companies. These improvements in operations do not come at the expense of fired employees, the U.S. Treasury, bondholders, or public shareholders.

Now, this evidence is taken from an analysis of a sample of larger management buyouts of public companies that were completed between 1980 and 1986. My study makes the following findings:

After the buyout, buyout companies increase operating income by 20 to 30 percent more than other companies in the same industry. At the same time, they keep capital expenditures 10 to 20 percent lower. Net cash flows by 50 to 60 percent more than other companies in the same industry. I think this evidence gives strong support that these companies are managed better after the buyout.

These results should also be interpreted in light of the fact that the companies are not high-tech companies—only seven of the original 76 companies in my sample reported R&D expenditures in the year prior to the buyout—these tended to be low-tech companies in mature industries.

There is no evidence that large numbers of employees are fired. Employment in the typical buyout actually goes up; when you take account of divestitures and acquisitions, they increase about 4.9 percent.

We should also bear in mind that, over the period 1981 to 1987, General Electric reduced its work force by over 100,000 people. No takeover, no management buyout.

As far as taxes are concerned, the IRS may gain from these transactions when you add up all the pluses and minuses. It is true that the deductibility of interest provides a tax benefit to the buyout companies; at the same time, buyouts do generate tax payments that are often ignored. These include capital gains taxes paid by selling shareholders, taxes that lenders pay on interest income, and taxes that the buyout companies will pay on the increased operating income base that they generate because of the buyout.

The available empirical evidence also does not support the view that bondholders systematically lose in these transactions. While bondholders lose in some cases, the empirical evidence suggests that bondholders come out about even, on average.

Finally, there are several additional pieces of evidence that don't support the view that buyout companies hide information from public shareholders.

First, buyout companies do not outperform the projections that they provide to public shareholders when the companies go private.

Second, in most buyouts there are informed officers and directors who voluntarily refrain from participating in the management buyout.

And third, there is competition. Many management buyout proposals are outbid by third parties, and RJR provides a vivid example—the initial bid of $76 by RJR management was too low; it quickly attracted two counter-offers, and management lost.

It is also worth stressing that my results, as well as most of the debate on management buyouts, pertain to public companies. There is reason to believe that the results would be even stronger for management buyouts of divisions and of private companies.

As with most innovations, some mistakes have been made, and some will be made in the future. These tend to receive a great deal of attention from the press. However, the experience of the typical management buyout has been a positive one. Buyout companies make operating improvements that don't come at the expense of fired employees, the Treasury, bondholders, public shareholders.

Legislative proposals which would limit the deductibility of interest payments on corporate debt would reduce the price an investor group could pay public shareholders in a given transaction. In any contest for control of a company, this would give an advantage to foreign bidders and to large diversified corporations which would not be affected by the interest limitations.

There is evidence that acquisitions by large diversified corporations destroy value rather than create it. Limitations on interest deductibility, therefore, would encourage bad takeovers at the expense of management buyouts. In light of the results in my study, I would oppose such legislation.

Legislative proposals to remove the double taxation of dividends do not favor bad takeovers over management buyouts. Accordingly, I would be in agreement with removing the double taxation of dividends, as long as the deductibility of interest was not affected.

Thank you for having me.

[The prepared statement of Mr. Kaplan appears in the appendix.]

The CHAIRMAN. Mr. Kaplan, I see that you have done considerable empirical research on the effect of LBOs and have written some books in that regard. Does your analysis lead to the result that you think all publicly-traded companies ought to go private?

Mr. KAPLAN. No. I think that you tend to see buyouts industries that are mature, with companies that have a lot of cash. And RJR Nabisco is a perfect example. It has a cigarette business that almost manufactures money, and RJR doesn't have profitable investment opportunities in its own business.

Philip Morris took one route. They paid it to Kraft shareholders— RJR Nabisco paid the money to RJR shareholders— RJR Nabisco shareholders are going to do very, very well, because instead of seeing that money go into investments that have very low return, the money goes to the shareholders who can then invest that money in other projects that have higher returns.

The CHAIRMAN. Let me ask you, did many of those companies get tax-free funds on account of loss-carrybacks to pre-buyout years?

Mr. KAPLAN. About one half of the companies could not carry back losses because they wrote up their assets. Some of the other half of the companies did carry back tax losses.

The CHAIRMAN. Yes, I understand that; but I am asking you, did many of them get it? Did they apply for it?

Mr. KAPLAN. If you look at what happens to the taxability of the companies afterward, typically in the first two years after the buyout the companies don't pay any Federal income taxes. In the third year, however, their operating income has picked up, and you will find that they do pay taxes again, and that the level is almost up to where it was before the buyout.

The CHAIRMAN. Mr. Kaplan, we will have a number of questions we will want to submit to you in writing, and we want your answers put in the record, and we will have some from the Joint Tax Committee.

Mr. KAPLAN. Yes, sir.

[The questions appear in the appendix.]

The CHAIRMAN. Senator Packwood?

Senator PACKWOOD. Let me ask you one or two:

You are a wonderful writer. I enjoyed reading your statement. But there is one sentence I was particularly intrigued with.

Mr. KAPLAN. Thank you.

Senator PACKWOOD. "It is important to separate the net tax position of the buyout company from the net tax position of the IRS."

Mr. KAPLAN. That is correct.

Senator PACKWOOD. Sometimes we think there is only one position, and that is the government's net tax position.

Let me paraphrase what you said, and you tell me if I am saying it wrong: On average, the net tax position of the IRS —i.e., do they collect more than they would otherwise collect—is improved by leveraged buyouts.

Mr. KAPLAN. That is correct. That depends upon the assumptions; but, under assumptions that I find plausible, the answer is yes.

Senator PACKWOOD. And you are averaging; you are talking about the net position. There may be some where it isn't true, but the additional money to the shareholders and the other people, the increased interest on the bonds to the people that have to pay taxes, more than offset the losses, and, on net, the IRS comes out ahead.

Mr. KAPLAN. That is correct.

Senator PACKWOOD. A very interesting conclusion. I found your paper very, very good. Thank you for being so patient in waiting.

Mr. KAPLAN. Thank you.

The CHAIRMAN. Mr. Kaplan, thank you very much.

That concludes this set of hearings on the LBOs.

Mr. KAPLAN. Thank you very much.

[Whereupon, at 12:25 p.m., the hearings were concluded.]

APPENDIX

ALPHABETICAL LIST AND MATERIAL SUBMITTED

PREPARED STATEMENT OF JOHN J. CREEDON

PRESIDENT AND CHIEF EXECUTIVE OFFICER
METROPOLITAN LIFE INSURANCE CO.

BACKGROUND

Metropolitan Life is a mutual life insurance company, providing insurance coverage and other benefits to over 42 million people in the united States and Canada. As such, it has the responsibility and the duty to invest the funds supporting its obligations to its customers not only to their financial advantage, but also prudently and, to the extent possible, in the public's economic interest.

Met Life has historically provided long term fixed rate capital to industry. One of the reasons we are here today is because we believe that the ability of long term investors to continue to fulfill that critical function is being seriously threatened by certain recent developments in the financial markets: the proliferation of corporate takeovers, recapitalizations and restructurings.

Our total investment portfolio under management currently exceeds $115 billion, of which about $75 billion is compromised of long term bonds and mortgage loans on real estate. In 1988 alone, our gross new long term investments totaled almost $30 billion.

We have always emphasized quality in our investment activities, as attested to by our consistent portfolio ranking at the very top of the insurance industry and our triple-A rating from both Moody's and Standard & Poor's.

Thus, Met Life and its policyholders have a very considerable stake in the continued health and vitality of the U.S. economy and its capital markets in particular.

THE PROBLEM

At the outset in addressing the subject at hand, let me make it clear that Met Life is not opposed to mergers and acquisitions, leveraged buyouts, recapitalizations or other similar transactions per se. Indeed, Met Life has invested in some such transactions with very favorable financial results.

As the leveraged marketplace has evolved over the past few years of economic growth and prosperity, however, Met Life has grown increasingly concerned over several aspects of this phenomenon. (It is important to note, in this regard, that while most of the public attention has been devoted to leveraged buyouts and other merger and acquisition techniques, a number of transactions - some of which were defensive - have taken place involving recapitalizations and/or restructurings which did not necessarily involve a change in ownership, but which had similar effects from the standpoint of leverage).

Our first concern is that we fear the American economy is becoming overleveraged, imperilling its ability to withstand a serious economic downturn, and thereby threatening its competitive position in world markets.

In an article in the first quarter 1988 Brookings Papers on Economic Activity, Ben S. Bernanke and John Y. Campbell, both of Princeton University, surveyed the data of COMPUSTAT firms to gauge the effects of recession on corporate financial structures. Using debt/asset ratios they concluded that a repetition of the 1973-74 recession "would lead to unprecedented debt/asset ratios" and that "for at least 10 percent of firms, the simulated debt/asset ratios exceed unity, indicating bankruptcy." The study did not attempt to evaluate any negative multiplier effects on lenders and the economy generally, which might subsequently contribute to another round of financial problems.

The same Brookings study estimated that the percentage of cash flow which must be devoted by American business to making "real" interest payments has increased from 5% in 1970-1980 to 25% in 1988.

Flow of funds data published by the Federal Reserve Board indicate that between 1984 and 1987 corporations reduced outstanding equity by $313 billion. In the first three quarters of 1988, the trend continued at an annual rate of almost $110 billion.

The problems of excessive corporate leveraging can, in part, be rationalized through the free market mechanism, though not without risk. However, the recent unprecedented volume of leveraged transactions is difficult to control through private initiatives and represents an area where government policy options should be explored.

Our second concern is that we have observed an increasing incidence of transactions which, in our view, are little more than financial manipulation, in contrast to transactions which increase productive capacity, create new jobs or improve efficiency.

To an increasing extent we are seeing transactions which simply constitute the massive substitution of debt obligations for equity. Far from producing a positive economic impact, these transactions frequently result in decreases in employment, shutdowns of plants and other productive resources, dislocations within local communities, and, indeed, the breakup of business combinations which appear to make eminent economic sense.

Our final concern is that leveraged transactions must result in fair and equitable treatment for all concerned constituencies, including shareholders, employees and creditors. In at least one notable recent transaction - RJR Nabisco - this clearly was not the case, as bondholders suffered a $1 billion reduction in the value of their investment virtually overnight (from $5 billion to approximately $4 billion).

Normally, the long term interests of all the constituencies affected by our large corporations are naturally synchronized.

Given the incentives and economic regulation of the free market, all the corporation's constituencies benefit by its health and growth over the long term.

However, the highly leveraged transaction frequently provides for substantial short term benefits for some of the corporation's constituencies at the cost of short term or long term losses to its other constituencies. The shareholders may receive immediate enrichment, but that enrichment is often partly or wholly at the expense of other constituencies. Thus, long term bondholders often suffer an immediate loss of market value, employees may experience a loss of jobs, the communities in which the corporation operates may undergo serious disruptions, and there are other long term risks to the national economy.

SOME ALTERNATIVES

We believe that curbing the excesses and abuses which have developed in the marketplace, and which I cited earlier, should be a high priority objective of all concerned, including legislators, regulators, investors and corporate executives and directors.

While we have reviewed a number of published proposals and evaluated some of our own ideas as to accomplishing this objective through legislative means, we do not feel confident in endorsing any of the alternatives which we have seen to date as a total solution.

While a free market solution, which itself is not without risk, will hopefully help the situation long term, there are two areas which we believe are deserving of further legislative attention.

The first is that of corporate governance. We believe that the duties and responsibilities of corporate boards of directors and managements may be in need of clearer legislative definition as they relate to the fair and equitable treatment of all parties at interest.

In our view, managements and boards of directors do have the responsibility to weigh the interests of all the constituencies in managing the corporation. A number of states have now amended their corporate governance laws to expressly authorize a corporation's board, in discharging its duties, to consider the interests of constituents other than its shareholders - including other security holders, suppliers, customers, employees, its community and the nation's economy - and to look to the long term interests of the corporation, rather than to limit its focus to short term gains for current shareholders.

We endorse these clarifications of state law. We encourage other states to follow suit, particularly Delaware. We would also support the modification of ERISA to make it clear that plan trustees may take a longer range view of corporations whose stock they hold and need not always take the short term gain to be obtained by accepting a tender offer.

Consistent with these concepts, we would support amendment of the Williams Act so that issuers be required to fully disclose, in addition to their position with respect to a tender offer, the probable consequences of the tender offer on all the corporation's constituencies.

The second area we recommend for evaluation is the subject of this Committee's deliberations. Tax policy is the only practical tool we have seen suggested which constitutes a proactive method of curbing the current excesses in the near term, though it is fraught with conflicts and complexities.

There are valid reasons for the historical distinction between the tax treatments afforded to debt interest and equity dividends. In the current environment, however, debt is being substituted for equity and is, therefore, equity ipso facto.

Thus, in effect "equityholders" are receiving contractual "dividends" which are deductible by the corporation because in form they are interest on debt. This encourages debt incurrence to the detriment of maintaining a sound equity base to fund future growth and protect the company against economic adversity.

Some proposals would attack the overleveraging problem by instituting a deductibility cap based on the debt/equity ratio of corporations. Acceptable capitalization ratios vary significantly amongst industries both in practice and in terms of "norms" acceptable to potential investors. For example, capital-intensive industries, finance companies and utilities traditionally have been able to make above average use of leverage without impairing their financial health. Measurement problems are illustrated by the fact that older established companies with substantially depreciated assets may not come close to reflecting their true economic debt/equity ratios on an accounting basis.

Limiting deductibility of interest on "junk" bonds is a generalized proposal being expressed in some circles. Bonds receive ratings below investment grade for many reasons and not all such financings should be discouraged. Newer and smaller companies, where job creation and economic growth tend to be strong, would be hurt by such policy. Many such companies start out by borrowing in the direct placement market as well as in the public markets and eventually "grow up" to a stronger rating category. Another concern would be for companies that encounter difficult times because of business cycle impacts or adverse industry conditions. Earnings losses, under rigid definitions used for tax purposes, could trigger some form of junk bond determination, limit the deductibility of interest paid on the bonds and precipitate or accelerate financial problems for the bond issuer.

Nonetheless, it may be possible to limit non-deductibility to situations in which a predetermined amount or proportion of debt is created specifically to facilitate an acquisition or a defensive recapitalization.

Another tax approach that might be appropriate would be to reestablish a capital gains tax differential based upon the holding period. This concept would seem to be deserving of very serious consideration as a means of encouraging equity accumulation and discouraging transactions designed solely to produce profits in the short term.

While we do not have specific tax proposals to recommend at this time, we certainly applaud the efforts of this Committee to ensure that tax policy encourages, if not requires, a healthy balance of debt and equity in the capital structure of America's industrial economy.

As a final point from a regulatory standpoint, the junk bond phenomenon may also result in the circumvention of statutory limitations to which some investors are subject. Such provisions limit the proportion of an institution's portfolio which may be invested in "equity securities." For example, New York insurance law limits "equity" investments to 20% of an insurer's assets. To the extent that "junk" debt is, in reality, equity, the statutory limitations would not seem to apply. To address this problem, Superintendent Corcoran of New York has promulgated a regulation also limiting junk bonds to 20% of an insurer's total assets. We believe this area is also one which bears examination.

Regardless of the alternative solutions being considered, it is important that the members of this Committee understand that the investment community's willingness to continue to provide long term fixed rate capital to the American economy is in serious jeopardy in the current environment. Investors will not be willing to invest long term if the value of their holdings can be precipitously reduced solely as a result of leveraged buyouts or other corporate restructurings. Signs of this reluctance to invest long term have already appeared in the corporate bond market, and thus far the provisions proposed for new public issues to protect bondholders against such losses appear to be inadequate.

In essence, we believe that an informed, efficient free market should be a major part of the ultimate solution. To this end, Met Life is considering undertaking a public information campaign intended to heighten awareness of these important economic issues in the hope that a more enlightened public will better understand the risks inherent in the current investment environment and the threat which they pose to the capital markets which constitute such a vital cornerstone of our economic prosperity.

PREPARED STATEMENT OF ALAN GREENSPAN

CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. Chairman and other members of the Senate Finance Committee, I am pleased to be here today to address issues raised by recent trends in corporate restructuring activity. The spate of mergers, acquisitions, leveraged buyouts, share repurchases, and divestitures in recent years is a significant development. It has implications for shareholders, the efficiency of our companies, employment and investment, financial stability, and, of course, tax revenues and our tax system. While the evidence suggests that the restructurings of the 1980s probably are improving, on balance, the efficiency of the American economy, the worrisome and possibly excessive degree of leveraging associated with this process could create a set of new problems for the financial system.

Corporate restructuring is not new to American business. It has long been a feature of our enterprise system, a means by which firms adjust to ever-changing product and resource markets, and to perceived opportunities for gains from changes in management and management strategies.

Moreover, waves of corporate restructuring activity are not new. We experienced a wave of mergers and acquisitions around the turn of this century and again in the 1920s. In the postwar period, we witnessed a flurry of so-called conglomerate mergers and acquisitions in the late 1960s and early 1970s.

However, the 1980s have been characterized by features not present in the previous episodes. The recent period has been marked not only by acquisitions and mergers, but also by significant increases in leveraged buyouts, divestitures, asset sales, and share repurchase programs. In many cases, recent activity reflects the break-up of the big conglomerate deals packaged in the 1960s and 1970s. Also, the recent period has been characterized by the retirement of substantial amounts of equity (more than $500 billion since 1983) mostly financed by borrowing in the credit markets.

The accompanying increase in debt has resulted in an appreciable rise in leverage ratios for many of our large corporations. Aggregate book value debt-equity ratios, based on balance sheet data for nonfinancial firms, have increased sharply in the 1980s, moving outside their range in recent decades, although measures based on market values have risen more modestly.

Along with this debt expansion, the ability of firms in the aggregate to cover interest payments has deteriorated. The ratio of gross interest payments to corporate cash flow before interest provision is currently around 35 percent, close to the 1982 peak when interest rates were much higher. Moreover, current interest coverage rates are characteristic of past recession periods, when weak profits have been the culprit. Lately profits have been fairly buoyant; the current deterioration has been due to heavier interest burdens.

A measure of credit quality erosion is suggested by an unusually large number of downgradings of corporate bonds in recent years. The average bond rating of a large sample of firms has declined since the late 1970s from A+ to A-.

Causes of Restructuring Activity

To fashion an appropriate policy response, if any, to this extraordinary phenomena, there are some key questions that must be answered: What is behind the corporate restructuring movement? Why is it occurring now, in the middle and late 1980s, rather than in some earlier time? Why has it involved such a broad leveraging of corporate balance sheets? And finally, has it been good or bad for the American economy?

The 1980s has been a period of dramatic economic changes: large swings in the exchange value of the dollar, with substantial consequences for trade-dependent industries; rapid technological progress, especially in automation and telecommunications; rapid growth in the service sector; and large movements in real interest rates and relative prices. Clearly, such changes in the economic environment imply major, perhaps unprecedented, shifts in the optimal mix of assets at firms--owing to corresponding shifts in synergies--and new opportunities for improving efficiency. Some activities need to be shed or curtailed, and others added or beefed up. Moreover, the long period of slow productivity growth in the 1970s may have partly exacerbated the buildup of a backlog of inefficient practices.

When assets become misaligned or less than optimally managed, there is clearly an increasing opportunity to create economic value by restructuring companies, restoring what markets perceive as a more optimal mix of assets. But restructuring requires corporate control. And managers, unfortunately, often have been slow in reacting to changes in their external environment, some more so than others. Hence, it shouldn't be a surprise that, in recent years, unaffiliated corporate restructurers, some call them corporate raiders, have significantly bid up the control premiums over the passive investment value of companies that are perceived to have suboptimal asset allocations. If a company has an optimal mix there is no economic value to be gained from restructuring and, hence, no advantage in obtaining control of a company for such purposes. In that case, there is no incentive to bid up the stock price above the passive investment value based on its existing, presumed optimal, mix of assets. But in an economy knocked partially off kilter by real interest rate increases and gyrations in foreign exchange and commodity prices, there emerge significant opportunities for value-creating restructuring at many companies.

This presumably explains why common stock tender offer prices of potential restructurings have risen significantly during the past decade. Observed stock prices generally (though not always) reflect values of shares as passive investments. But there are, for any individual company, two or more prices for its shares, reflecting the degree of control over a company's mix of assets.

Tender-offer premiums over passive investment values presumably are smaller than control premiums to the extent that those making tender offers believe that, restructured, the value of shares is still higher than the tender. Nonetheless, series on tender-offer premiums afford a reasonable proxy of the direction of control premiums.

Such tender-offer premiums ranged from 13 to 25 percent in the 1960s, but have moved to 45 percent and higher during the past decade, underscoring the evident increase in the perceived profit to be gained from corporate control and restructuring.

Interest in restructuring also has been spurred by the apparent increased willingness and ability of corporate managers and owners to leverage balance sheets. The gradual replacement of managers who grew up in the Depression and developed a strong aversion to bankruptcy risk probably accounts for some of the increased proclivity to issue debt now.

Moreover, innovations in capital markets have made the increased propensity to leverage feasible. It is now much easier than it used to be to mobilize tremendous sums of debt capital for leveraged purchases of firms. Improvements in the loan-sale market among banks and the greater presence of foreign banks in U.S. markets have greatly increased the ability of banks to participate in merger and acquisition transactions. The phenomenal development of the market for low-grade corporate debt, so-called "junk bonds," also has enhanced the availability of credit for a wide variety of corporate transactions. The increased liquidity of this market has made it possible for investors to diversify away firm-specific risks by building portfolios of such debt.

The tax benefits of restructuring activities are, of course, undeniable, but this is not a particularly new phenomenon. Our tax system has long favored debt finance by taxing the earnings of corporate debt capital only at the investor level, while earnings on equity capital are taxed at both the investor and corporate levels. There have been other sources of tax savings in mergers that do not depend on debt finance, involving such items as the tax basis for depreciation and foreign tax credits. And taxable owners benefit when firms repurchase their own shares, using what is, in effect, a tax-favored method of paying cash dividends. In any event, the recent rise in restructuring activity is not easily tied to any change in tax law.

Evidence about the economic consequences of restructuring is beginning to take shape, but much remains conjectural. It is clear that the markets believe that the recent restructurings are potentially advantageous. Estimates range from $200 billion to $500 billion or more in paper gains to shareholders since 1982. Apparently, only a small portion of that has come at the expense of bondholders. These gains are reflections of the expectations of market participants that the restructuring will, in fact, lead to a better mix of assets within companies and greater efficiencies in their use. This, in turn, is expected to produce marked increases in future productivity and, hence, in the value of American corporate business. Many of the internal adjustments brought about by changes in management or managerial policies are still being implemented, and it will take time before they show up for good or ill in measures of performance.

So far, various pieces of evidence indicate that the trend toward more ownership by managers and tighter control by other owners and creditors has generally enhanced operational efficiency. In the process, both jobs and capital spending in many firms have contracted as unprofitable projects are scrapped. But no clear trends in these variables are yet evident in restructured firms as a group. For the business sector, generally, growth of both employment and investment has been strong.

If what I've outlined earlier is a generally accurate description of the causes of the surge in restructurings of the past decade, one would assume that a stabilization of interest rates, exchange rates, and product prices would slow the emergence of newly misaligned companies and opportunities for further restructuring. Such a development would presumably lower control premiums and reduce the pace of merger, acquisition, and LBO activity.

This suggests that the most potent policies for defusing the restructuring boom over the long haul are essentially the same macroeconomic policies toward budget deficit reduction and price stability that have been the principal policy concerns of recent years.

Financial Risks

Whatever the trends in restructuring, we cannot ignore the implications that the associated heavy leveraging has for broad-based risk in the economy. Other things equal, greater use of debt makes the corporate sector more vulnerable to an economic downturn or a rise in interest rates. The financial stability of lenders, in turn, may also be affected. How much is another question. The answer depends greatly on which firms are leveraging, which financial institutions are lending, and how the financings are structured.

Most of the restructured firms appear to be in mature, stable, non-cyclical industries. Restructuring activity has been especially prevalent in the trade, services, and, more recently, the food and tobacco industries. For such businesses, a substantial increase in debt may raise the probability of insolvency by only a relatively small amount. However, roughly two-fifths of merger and aquisition activity, as well as LBOs, have involved companies in cyclically sensitive industries that are more likely to run into trouble in the event of a severe economic downturn.

Lenders to leveraged enterprises have been, in large part, those that can most easily absorb losses without major systemic consequences. They include mutual funds, pension funds, and insurance companies, which generally have diversified portfolios, have traditionally invested in securities involving some risk, such as equities, and are not themselves heavily leveraged. To the extent that such debt is held by individual institutions that are not well diversified, there is some concern. At the Federal Reserve, we are particularly concerned about the increasing share of restructuring loans made by banks. Massive failures of these loans could have broader ramifications.

Generally, we must recognize that the line between equity and debt has become increasingly fuzzy in recent years. Convertible debt has always had an intermediate character, but now there is almost a continuum of securities varying in their relative proportions of debt and equity flavoring. Once there was a fairly sharp distinction between being unable to make interest payments on a bond, which frequently led to liquidation proceedings, and merely missing a dividend. Now the distinction is much smaller. Outright defaults on original issue high-yield bonds have been infrequent to date, but payment difficulties have led to more frequent exchanges of debt that reduce the immediate cash needs of troubled firms. Investors know when they purchase such issues that the stream of payments received may well differ from the stream promised, and prices tend to move in response to changes in both debt and equity markets. In effect, the yields on debt capital rise toward that of equity capital when scheduled repayments are less secure.

Policy Implications

In view of these considerations, and the very limited evidence on the effects of restructuring at the present time, it would be unwise to arbitrarily restrict corporate restructuring. We must resist the temptation to seek to allocate credit to specific uses through the tax system or through the regulation of financial institutions. Restrictions on the deductibility of interest on certain types of debt for tax purposes or on the granting of certain types of loans unavoidably involve an important element of arbitrariness, one that will affect not only those types of lending intended but other types as well. Moreover, foreign acquirers could be given an artificial edge to the extent that they could avoid these restrictions. Also, the historical experience with various types of selective credit controls clearly indicates that, in time, borrowers and lenders find ways around them.

All that doesn't mean that we should do nothing. The degree of corporate leveraging is especially disturbing in that it is being subsidized by our tax structure. To the extent that the double taxation of earnings from corporate equity capital has added to leveraging, debt levels are higher than they need, or should, be. Our options for dealing with this distortion are, unfortunately, constrained severely by the federal government's still serious budget deficit problems. One straightforward approach to this distortion, of course, would be to substantially reduce the corporation income tax. Alternatively, partial integration of corporate and individual income taxes could be achieved by allowing corporations a deduction for dividends paid or by giving individuals credit for taxes paid at the corporate level. But these changes taken alone would result in substantial revenue losses. A rough estimate of IRS collections from taxing dividends is in the $20 to $25 billion range.

Dangers of risk to the banking system associated with high debt levels also warrant attention. The Federal Reserve, in its role as a supervisor of banks, has particular concerns in this regard. In 1984, the Board issued supervisory guidelines for assessing LBO-related loans, which are set forth in an attachment to my text. The Federal Reserve is currently in the process of reviewing its procedures regarding the evaluation of bank participation in highly leveraged financing transactions. The circumstances associated with highly leveraged deals require that creditors exercise credit judgment with special care. Doing so entails assessing those risks that are firm-specific as well as those common to all highly leveraged firms.

ATTACHMENT

The Federal Reserve's directive to examiners on leveraged buyout loans, issued in 1984, provided the following supervisory guidance to supplement standard loan review procedures:

> The nature of leveraged buyouts and, in particular, the level of debt typically involved in such arrangements give rise to supervisory concerns over the potential risk implications for bank loan portfolios. The high volume of debt relative to equity that is characteristic of leveraged buyouts leaves little margin for error or cushion to enable the purchased company to withstand unanticipated financial pressures or economic adversity. Two principal financial risks associated with leveraged buyout financing are: (1) the possibility that interest rates may rise higher than anticipated and thereby significantly increase the purchased company's debt service burden; and/or (2) the possibility that the company's earnings and cash flow will decline or fail to meet projections, either because of a general economic recession or because of a downturn in a particular industry or sector of the economy. While either one of these developments can undermine the creditworthiness of any loan, the high degree of leverage and the small equity cushion typical of most leveraged buyouts suggest that economic or financial adversity will have a particularly large and negative impact on such companies. Thus, a leveraged buyout arrangement that appears reasonable at a given rate of interest or expected cash flow can suddenly appear to be questionable if interest rates rise significantly or if earnings should fail to provide an adequate margin of coverage to service the acquisition debt.
>
> In addition to unfavorable interest rate movements and earnings developments, adverse economic conditions may also have a negative impact on the value of a company's collateral. For example, if a general economic slowdown reduces a company's sales and earnings, the marketability and value of its collateral may also suffer. In any event, given the amount of debt involved in leveraged buyouts, the value of collateral is extremely important, and the risk that collateral coverage may be insufficient to protect the bank is a significant factor in evaluating the creditworthiness of these loans. In light of all of these considerations, the quality of a purchased company's management is also extremely important and represents another critical element in the bank's evaluation of leveraged buyouts. This is because such management must oversee both the special financial risks associated with the leveraged buyout form of acquisition financing as well as the normal day-to-day affairs and operations of the purchased company's business.
>
> In the course of on-site examinations, examiners should review a bank's involvement in leveraged buyout financing as well as the loans associated with individual leveraged buyouts. The following general

guidelines are provided to underscore and supplement existing loan review procedures.

1. In evaluating individual loans and credit files, particular attention should be addressed to i) the reasonableness of interest rate assumptions and earnings projections relied upon by the bank in extending the loan; ii) the trend of the borrowing company's and the industry's performance over time and the history and stability of the company's earnings and cash flow, particularly over the most recent business cycle; iii) the relationship between the company's cash flow and debt service requirements and the resulting margin of debt service coverage; and iv) the reliability and stability of collateral values and the adequacy of collateral coverage.

2. In reviewing the performance of individual credits, examiners should attempt to determine if debt service requirements are being covered by cash flow generated by the company's operations or whether the debt service requirements are being met out of the proceeds of additional or ancillary loans from the bank designed to cover interest changes.

3. Policies and procedures pertaining to leveraged buyout financing should be reviewed to ensure that they incorporate prudent and reasonable limits on the total amount and type (by industry) of exposure that the bank can assume through these financing arrangements.

4. The bank's pricing, credit policies, and approval procedures should be reviewed to ensure i) that rates are reasonable in light of the risks involved and ii) that credit standards are not compromised in order to increase market share. Credit standards and internal review and approval standards should reflect the degree of risk and leverage inherent in these transactions.

5. Total loans to finance leveraged buyouts should be treated as a potential concentration of credit and if, in the aggregate, they are sufficiently large in relation to capital, the loans should be listed on the concentrations page in the examination report.

6. Significant deficiencies or risks regarding a bank's leveraged buyout financing should be discussed on page 1 of the examination report and brought to the attention of the board of directors.

Steven N. Kaplan

A SUMMARY OF SOURCES OF VALUE IN MANAGEMENT BUYOUTS[1]

I. INTRODUCTION

The RJR Nabisco leveraged buyout has focused America's attention on management buyouts, high yield bonds and the general effects of corporate leverage. There has been a tremendous amount of controversy concerning where the money in buyouts comes from. How can RJR stock be worth $55 per share before the buyout was announced, but close to $100 when the bidding is over? In the management buyouts of public companies that I have studied, the total premium or added value in the buyouts has averaged approximately 100% net of market movements. These gains are particularly puzzling because the assets of the buyout do not magically change the day it goes from a public company to a private one. My work has tried to say something sensible about where this value comes from. There are five basic views.

There's the efficiency view that buyouts combine several powerful incentives which create value by making operations more efficient. The large debt service payments force managers to find ways to generate cash and prevent managers from spending money unproductively. Larger equity stakes give managers an incentive to pay off the debt. And the buyout promoter or specialist makes sure that the management team does what it is supposed to.

In opposition to this value creation view, critics have charged that the buyouts do not create any useful value at all, but rather, transfer it from other parties to the buyout investors.

There's the tax view that the IRS finances the gains through the interest deductions in these transactions.

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[1] This paper summarizes evidence found in (i) Steven Kaplan, "Management Buyouts: Efficiency Gains or Value Transfers," Center for Research in Security Prices (CRSP), Graduate School of Business, University of Chicago, Working Paper #244, 1988; (ii) Steven Kaplan, "Management Buyouts: Evidence on Taxes as a Source of Value," CRSP, Graduate School of Business, University of Chicago, Working Paper #245; and (iii) Michael Jensen, Steven Kaplan and Laura Stiglin, "Effects of LBOs on Tax Revenues of the U.S. Treasury," unpublished manuscript, Harvard Business School.

There's the labor view that most of the gains come from firing employees.

There's the view that the gains come as transfers from the old bondholders.

And finally, there's the underpricing view that the market doesn't price some companies correctly. Managers and buyout investors know a great deal about the company that public shareholders and other potential bidders do not. Under this view, public shareholders are stuck with a low price while the buyout investors end up with a hidden, but very valuable "pot of gold."

From a public policy perspective, buyouts should be encouraged if they generate operating improvements. To the extent that the buyouts simply transfer value, they should be discouraged.

The evidence from my study supports the view that management buyouts create more efficiently operated companies. These improvements in operations do not come at the expense of employee firings, the IRS, bondholders or public shareholders. This evidence is taken from an analysis of a sample of 76 larger management buyouts of publicly traded companies completed between 1980 and 1986. These companies were taken private at a cost of at least $50 million. 48 of these 76 companies have usable post-buyout financial information. The results which follow are based on this information.

My study makes the following findings:

(1) After the buyout, buyout companies increase operating income by 20% to 30% more than other companies in the same industry. At the same time, they keep capital expenditures 10% to 20% lower. Net cash flow, the difference between operating income and capital expenditures increases by 50% to 60% more than other companies in the same industry. All of these increases are highly statistically significant. This evidence gives strong support in favor of the existence of operating improvements.

(2) Contrary to the labor view, employment in the typical buyout increases after the buyout. This is not consistent with the systematic firing of large

numbers of employees.

(3) Contrary to the tax view, the IRS gains from buyout transactions. It is true that the deductibility of interest provides a tax benefit to the buyout companies. At the same time, however, buyouts generate tax payments that have been ignored by other researchers. These include the capital gains taxes paid by selling shareholders, the taxes that lenders pay on interest income and the taxes that the buyout companies pay on the increased operating income.

(4) Contrary to the bondholder view, the empirical evidence does not support the view that bondholders systematically lose in these transactions. When they do, the losses are very small compared to the gains to public shareholders.

(5) Indirect evidence is not supportive of the view that buyout companies hide information from public shareholders: (i) although the buyout companies outperform other companies in the same industry, the buyout companies do not outperform the projections of post-buyout operations provided to public shareholders at the time the companies go private; (ii) a significant number of informed officers and directors voluntarily refrain from participating in the management buyout; and (iii) as the case of RJR highlights, there is competition for these transactions - many management buyout proposals are outbid by third parties.

The remainder of this paper discusses these results in more detail.[2]

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[2] It is worth noting that these results as well as most of the debate on management buyouts pertains to public companies. There is reason to believe that the results would be even stronger for management buyouts of divisions. Managers of divisions with virtually no equity stake in their divisions suddenly become part owners of the company with strong incentives to manage efficiently. It is also more difficult to argue that the division managers have information that the top managers of the corporation do not. Finally, it is not possible to argue that bondholders are hurt - most outstanding bonds are issued by the parent company, not the division.

II. POST-BUYOUT OPERATIONS

My study begins with the question of whether there is any evidence for the operating changes claimed by buyout promoters. People who think the gains are transfers or on paper would predict that such changes do not exist.

II.1. OPERATING INCOME

First, I consider changes in operating income (before depreciation). This is a measure of cash flow generated by the company's operations. In the first three years after the buyout, operating income of the buyout firms is 20% to 30% higher than prior to the buyout. To allow for the possibility that the increased operating income is caused by industry factors and would have occurred without the buyout, the change in operating income is calculated net of the changes for other companies in the same industry. If RJR implements a similar increase, it will be worth $600 - $900 million per year in additional operating income.

II.2. CAPITAL EXPENDITURES

Next, I consider changes in capital expenditures. Proponents of the efficiency view argue that buyout companies are companies which generate too much free cash flow. They use this cash flow for ill-advised capital expenditures and acquisitions. The buyout forces these companies to stop wasting money, and, therefore increases value. It is important to recognize that investment does not always benefit society. Investment in unproductive projects wastes scarce capital resources by denying their use in productive ventures.

RJR Nabisco, again, provides an example. In its 1987 Annual Report, RJR announced plans to spend one billion dollars a year on new plant for its food businesses for the next four years. This compares to less than $500 million per year over the previous two years. And it compares to even lower capital expenditures by the food businesses of their competitors. To earn a reasonable

20% pre-tax return on the $4 billion investment would require, roughly, $800 million in additional operating profit each year. This would require a 67% increase in operating income over the $1.2 billion generated by RJR's entire food business in 1987. Is there that much growth in Oreo Cookies? Furthermore, RJR is spending a great deal of money on its Premier cigarette which has had a very poor reception from consumers.

To be fair to critics, decreases in capital expenditures might also be consistent with the claim that buyout companies do not invest enough following the buyout. Under this view, the buyouts destroy value rather than create it. In the first three years after the buyout, capital expenditures of the buyout firms in my sample are 10% to 20% lower than prior to the buyout. Again, this result controls for industry trends.

These results should be interpreted in light of the fact that the companies in the sample are not high-tech companies. Only 7 of the original 76 companies, for example, reported R&D expenditures greater than 1% of sales in the year prior to the buyout. These tended to be low-tech companies in mature industries. In my opinion, it the lower level of capital expenditures in these cases creates value.

II.3. NET CASH FLOW

Finally, I consider changes in net cash flow - the difference between operating income and capital expenditures. In the first three post-buyout years, net cash flow is approximately 50% to 60% higher than prior to the buyout. Again, this result controls for industry trends. The same experience for RJR, would increase RJR's net cash flow by more than one billion dollars per year. With these increases, the debt burden gets paid off.

II.4. SELECTION BIAS?

There is one potential caveat to these results. I began with 76 buyouts of at least $50 million in size. I have obtained and analyzed post-buyout data for only 48 of these.

It is conceivable that those companies without post-buyout financial information perform differently. There is no way to test this explicitly. I don't have the data. However, I can divide the sample into two groups: (1) those companies in the sample because they had public debt at the time of the buyout and must file financial reports with the SEC; and (2) those in the sample because they subsequently have sold equity to the public or have been sold. The companies which file with the SEC must file regardless of post-buyout performance. They are typically companies which financed the buyout with high yield bonds or which substituted debt for cash as part of the payment to public shareholders.

The evidence, however, does not support the existence of a selection bias. The changes in net cash flow are similar for the two samples of companies.

II.5. OVERALL

Overall, the results for changes in operating income and capital expenditures show that significant operating changes do occur after the buyout. The buyout companies generate more cash in the first three years after the buyout. This supports the view that the companies are managed more efficiently after the buyout.

III. CHANGES IN EMPLOYMENT

At this point, we have to ask if these operating improvements come at the expense of employees? Are employees fired? For the sample as a whole, employment in the typical company is 0.9% higher after the buyout than before the buyout. This result may be misleading because divisions are sold and bought after the buyout. When I take account of post-buyout divestitures and acquisitions, I find that employment increases in 61% of the buyouts, with a median rise of 4.9%.

To be fair to buyout critics, the increase in employment for the buyout companies is smaller than the increase for other companies in the same industry by 6.2%. I also could not measure whether wages decreased and I could not tell if some employees were fired while others were hired. The fact is, on average, the level increases. This should not be terribly surprising. If a company has to generate income to pay its debt, it needs employees to generate the income.

IV. TAXES

Given the existence of operating improvements, what can we say about taxes? First, I think it is important to separate the net tax position of the buyout company from the net tax position of the IRS.

Under current tax law, buyout companies receive tax benefits from the ability to deduct interest from taxable income. In my sample, I found, not surprisingly that interest deductions from the debt have been large. Depreciation write-ups which are no longer available were less important. The increased interest and depreciation deductions were large enough to push many buyouts into the ranks of negative taxable income in the first two post-buyout years. From a manager's perspective, expected tax benefits before 1986 may have been of the same order of magnitude as the premium paid to public shareholders. Post-1986, with a lower corporate tax rate, the present value of the tax deductions would be 58% to 80% of the premium paid to public shareholders.

The corporate tax benefits, however, come at a tax cost. In the typical transaction, the tax deductions on the interest payments at the corporate level are more than offset by tax payments to the IRS from other sources. First, the IRS gets large capital gains taxes from public shareholders that would not have otherwise been realized. In the RJR transaction, this will amount to over $2 billion. The IRS also receives tax payments that banks and holders of high yield bonds must pay on their interest income. Finally and most importantly, the IRS benefits from operating improvements, by being able to tax a higher income base. Under current tax law and the assumption that operating improvements will equal those obtained in the past, the increased tax revenues paid to the IRS exceed the decreased tax revenues from the interest deductions. In the year after the buyout, the increases exceed the losses by a ratio of 4 to 1. In present value terms, the increases exceed the losses by a ratio of between 1.1 and 1.9 to 1.

V. BONDHOLDERS

Another possible source of value is from old bondholders. Some of RJR Nabisco's long-term bonds lost 20% in expected value because of the buyout. While bondholders do lose in some cases, there is no evidence that bondholders lose on average.[3] Even in the case of RJR, only the bonds with the longest maturity lost 20% of their value. Bonds of shorter maturities lost little or no value. A liberal estimate of lost bondholder value in the RJR transaction of $500 million is only 5% of the $10 billion premium (assuming a $100 price) public shareholders will earn in the RJR transaction.

Two additional points should be made. First, the same individuals are the ultimate beneficiaries of both bonds and stocks. Those individuals would gladly trade a small loss on bonds for a large total gain. Second, purchasers of corporate bonds can protect against losses from large changes in leverage by requiring bond covenants or poison puts. Such provisions, however, reduce the rates that bondholders can receive on their bonds. By not requiring such provisions, the bondholders in RJR gambled that RJR would not undergo a restructuring and lost.

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[3] See L. Marais, K. Schipper and A. Smith, "Wealth Effects of going Private for Senior Securities," forthcoming, Journal of Financial Economics.

VI. UNDERPRICING

At this point, the evidence is still consistent with claims that the buyout investors and managers knew about the operating improvements before the buyout while the public shareholders did not. Buyout investors may have been able to pay shareholders a lower price than an informed third party would have paid.

There are several reasons why I think this is unlikely. First, in most buyouts, managers provide public shareholders with projections of sales and operating income. With the underpricing story, I should have found that the companies routinely did better than the projections. Instead, the opposite is true; the projections tend to be optimistic.

Second, underpricing implies that everybody who knows the quote "true" value of the company will invest in the buyout to get their pot of gold. In fact, many managers and directors sell their shares and leave the company. In my sample, those managers and directors who did not participate in the buyouts owned an average of $22 million or almost 10% of the company. This is irrational behavior if the buyout is significantly underpriced and if such insiders have the same information as the continuing management team. Moreover, these non-investors often sit on the committee of the board of directors that can reject a buyout proposal as inadequate.

Furthermore, buyouts of public companies are not announced or completed in a vacuum. If a price is low, a buyout announcement will trigger intense interest from other potential bidders. RJR provides a vivid example of this result. RJR management's initial low bid attracted two counterbids from non-management bidders. During the same time period as my sample, 46 companies announced large management buyouts which were not completed. 34 of these companies were taken over by a non-management bidder. At other times, other bidders trigger the buyout. Approximately 1/3 of the buyouts in my sample either defeated a competing offer or announced the buyout after a hostile party had accumulated a 5% (or greater) stake in the company.

VII. CONCLUSION

The evidence from my study supports the view that the new incentives associated with management buyouts create more efficiently operated companies. These improvements in operations do not come at the expense of employee firings, the IRS, bondholders or public shareholders.

As with most innovations, some mistakes have been made and some will be made in the future. These tend to receive a great deal of attention from the press. However, the experience of the typical management buyout has been a positive one.

Legislative proposals which would place limitations on the deductibility of interest payments on corporate debt would reduce the price an investor group would be willing to pay to public shareholders in a given transaction and, therefore, give an advantage to foreign bidders and to large, diversified corporations in any contest for control of a company. There is strong evidence in the academic literature that acquisitions by large, diversified corporations destroy value rather than create it. This kind of legislation would tend to encourage takeover activity of questionable value at the expense of management buyouts. In light of the results in my study, I would oppose such legislation.

89-3

Testimony of Lane Kirkland, President American Federation of Labor and Congress of Industrial Organizations Before the House Ways and Means Committee on Leveraged Buyouts

February 1, 1989

Mr. Chairman:

The AFL-CIO, on behalf of the 14 million working American men and women who are members of our 90 affiliated national and international unions, thanks you for conducting this hearing and affording me the opportunity to testify on the subject of leveraged buyouts and other highly leveraged corporate restructurings. We do so because the Committee's inquiry into the effect of the tax laws on corporate restructurings could not be more timely. We look forward to working with members of this Committee in addressing this phenomenon and its attendant impact on Americans. In addition, we hope to work closely with you and members of other appropriate committees--particularly the Education and Labor Committee--on other matters related to LBOs, including the crucial issue of pension terminations and reversions.

By any measure, the country as a whole, and working people in particular, are paying a wholly unacceptable price to the financial manipulators who arrange highly speculative, highly leveraged buyouts and takeover deals. The colorful newspaper accounts of "hostile maneuvers," "greenmail payments," "poison pills," and other arcane aspects of the "takeover game" are fascinating but misleading. These stories give little attention to the adverse impact of these deals on plain working people throughout the nation and on the economic health of their communities.

We estimate that the long list of mergers, takeovers and leveraged buyouts over the past decade has directly resulted in some 90,000 of our members losing their jobs (see attachment). Many thousands more have been forced to take wage and benefit reductions as a result of corporate restructuring and the replacement of equity with massive amounts of debt. All too often, this debt is assumed not for the purpose of industrial expansion or increased competitiveness, but as a stockmarket manipulation ploy which serves little purpose other than to line the pockets of speculators with fast-earned mega-profits, as well as their investment bankers and their lawyers with fees running into the millions. The employees of these companies, who do the hard work to be done, are frequently placed at great risk while billions of dollars are channelled into hands that neither create nor produce goods or services.

In many cases, it does not matter whether the initial hostile takeover is successful, only that the company has been put into play. For example, the takeover of Crown Zellerbach's James River Paper Company by James Goldsmith in 1985 was followed by the layoff of 1,000 employees. A subsequent attempt by Goldsmith to gain control of the Goodyear Rubber Company was successfully fought off by the firm. However, in doing so, Goodyear added $2.6 billion to its corporate debt, which led to the shutdown of its tire plant in Cumberland, Maryland, the loss of 800 jobs there, as well as sizeable reductions at the company's headquarters and in various shops making other products in Akron.

In 1986, Safeway Stores' defense against a takeover by the Haft group included the payment of greenmail, which left the Hafts with $100 million in profit for their efforts, and ended in a leveraged buyout under the auspices of Kohlberg, Kravis and Roberts. The company incurred a debt of about $4.1 billion and quickly embarked upon a program of shutdowns and sales of stores. The number of job losses at Safeway totalled about 9,500.

The common ingredient in these and other restructurings is a quantum increase in debt, which then gives rise to extraordinarily high servicing costs, pressures to cut wages and benefits, and close-downs or sales of assets and operations.

Win or lose, those who initiate the takeovers usually end up pocketing millions of dollars, often through the payment of "greenmail." Corporate management is often protected from the dire consequences of a takeover by specially-designed "golden parachutes." The losers in these deals, quite consistently, are none other than the stakeholders in the affected company, particularly the long-term workers, to whom "golden parachutes" are not available.

There is no rhyme or reason to this latest Wall Street bubble. A few years ago, when large companies were gobbling each other up, we were told that "bigger is better," that conglomeration helped corporations become stronger and more efficient to compete in the world economy. Now that the takeover craze has become finance-driven and corporate disintegration through leveraged buyouts is the rage, we are told that companies are more efficient when broken up and their assets are sold off piecemeal.

While the rest of the industrialized world soberly invests in the future, our financial elite--with the complicity of major banks, brokerage firms, investment houses, prestigious law firms, and the "best and brightest" graduates of our leading universities and business schools--is engaged in a drunken short-term speculative revel. Whether or not we crash and burn is not the question, only when and how many casualties there will be.

The AFL-CIO takes no pleasure in this prediction. We know that the ultimate price will not be paid by the dealmakers; they will take the money and run. Rather, it is working people--whose voices cannot now be heard amid the current financial uproar--who will suffer.

What, then, is to be done? There is a growing consensus that a large part of the grotesque profits from these deals stems from the tax system's disparate treatment of debt and equity. There are complex practical and technical problems that must be overcome in correcting the current situation, but we believe that those problems are not insuperable, and that the current system is creating such serious economic losses that corrective action must be taken by this Committee and the Congress.

Even if one were to take a much kinder and gentler view of LBOs and hostile takeovers than we do, one thing is clear: the United States government should not be subsidizing these questionable deals by providing tax subsidies. But this is precisely what the tax code does. The code accords a tax advantage--tax subsidy if you will--to financing corporate activities through debt rather than equity.

Indeed, since 1981, the relative tax advantage of corporate debt has increased as a result of the sharp cuts in individual and corporate marginal tax rates, to the point whereby debt could now be taxed at a rate as much as 87.5 percent lower than equity, compared to a differential of 19.7 percent prior to 1981.

As a result, according to the Federal Reserve Board, from 1981 to 1987, the non-financial corporate business sector retired $295 billion in equities while adding $813.2 billion to net corporate indebtedness.

The switching of corporate capital structures from equity to debt also undercuts the corporate contribution to the costs of running the federal government and generates revenue losses that make the solution of the federal budget deficit problem even more intractable. If the share of corporate income excluded from taxes as a result of interest payments had stayed at its 1980 level, the corporate tax base in 1985 would have been nearly $50 billion higher than it was in fact.

As a tax policy matter, there is no reason to treat a dollar of debt-financed income any differently from a dollar financed by an equity investment--in fact, the distinction between the two is one of degree rather than a hard and fast distinction in kind. And, as a matter of national economic policy, the preferential tax treatment of debt has resulted in the siphoning off of funds to corporate deal-makers that otherwise would have been used to increase the nation's productive capacity and potential. This switch to debt for non-productive paper transactions has added an element of risk and vulnerability to an already shaky and fragile economic situation.

As a practical matter, this Committee is faced with the following choice: to continue the present rules under which the U.S. Treasury subsidizes highly-leveraged deals despite their deleterious effects, or enact a limit on interest deduction for corporate debt. The choice between those alternatives, while complex in its successful accomplishment, is an easy one as a matter of principle. So that there can be no misunderstanding, I wish to stress that the only other alternative that has been mentioned--a new corporate deduction for dividend payments--makes no sense whatsoever, particularly under current circumstances, in which the government's fiscal situation precludes any tax change that promises a large revenue loss to the Treasury.

It is our position, then, that since Congress has come to the judgment that it is proper to be selective in determining which types of interest payments shall be deductible on individual tax returns, it is time, in the interest of sound public policy, to make similar discriminations with regard to the deductibility of interest on the various types of corporate debt.

The amendment to the code most closely fitted to the immediate problem would be to disallow the deduction for debt to finance an LBO, a takeover, or the retirement of equity. While I am not an expert in the technicalities of formulating and administering the federal corporation tax, it is my understanding--and this accords with common sense--that such an amendment would require careful safeguards to prevent the evasive recharacterization of debt that is in fact incurred for these purposes and detailed tracing rules to assure that debt originally incurred for these purposes is not turned over into deductible debt obligations. These are not easy tasks, but I am convinced that this Committee has the technical skills to devise a workable approach and that the need is so great and so plain and obvious that the effort must be made.

In addition, the AFL-CIO is opposed to "greenmail" payments and "golden parachutes." The practice of paying off departing management, in particular, adds a level of financial and personal insult to workers who have no similar protections.

Current law taxes "greenmail" payments through a 50 percent excise tax, while "golden parachutes" are taxed by a 20 percent excise. Since these practices are continuing, we believe the current provisions to be inadequate. We ask that the Committee look into further measures aimed at eliminating them.

I also wish to digress for just a moment to underline two other related points of great concern to American workers which stand separate from the tax issue I have just discussed but are important nonetheless.

First, there is a natural tendency to focus on new developments and to take long-standing and equally destructive practices for granted. Thus, the discussion today is almost exclusively about LBOs and hostile takeovers, while other forms of corporate restructurings are hardly mentioned at all.

Yet, from the long-term employee's standpoint, all reorganizations in which one corporation succeeds another are the same: the prevailing, or "new," employer is free to hire a new workforce and in so doing may terminate established bargaining relationships and cancel collective bargaining agreements in force.

We believe this is entirely unfair and contrary to the interests of working people and of a well-functioning economy. Permitting arbitrary conduct of this kind undermines the system of mutual employer-employee commitments that provides the foundation for high company productivity. That being the case, the AFL-CIO's first priority in the merger and acquisition area is a set of employee protections across these corporate transitions no matter what their form. We will pursue this agenda in this Congress before the proper committees.

Finally, since this Committee has joint jurisdiction over ERISA matters, I wish to note that the AFL-CIO strongly supports a change in that law, under which employers have unilaterally terminated pension plans and used excess assets to fund mergers and acquisitions. Since 1980, $18.7 billion has been taken from pension funds by employers, affecting some 1.9 million participants. Workers whose pension benefits have been terminated by corporate raiders or corporations targeted for takeover have been left with annuities whose value is far less than the original pension promise.

Our position on this issue is simple. The assets in a pension fund represent deferred wages for workers covered by the plan and are explicit trade-offs in exchange for a pension that is expected to grow in the future and provide economic security to retirees. Thus, in the context of both merger activity and pension reform, we strongly urge Congress to develop comprehensive legislation that will end the termination of pension plans without significant worker participation and protection. The 10-percent excise on pension plan terminations was raised to 15 percent as part of the 1988 Technical Corrections Act to give Congress the opportunity to develop a comprehensive strategy on the issue of pension plan terminations. We stand ready to assist in developing whatever legislation is required to address this problem.

This completes my testimony. I will be happy to answer any questions members of the Committee might have.

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Number of Jobs Lost as a Result of Takeover Attempts, Takeovers, and Leveraged Buyouts

Unions Involved	Circumstances	Estimated Number of Jobs Lost
United Food and Commercial Workers	Safeway Stores was subject to a takeover attempt by the Dart Group Corp., owned by the Haft family of the Maryland suburbs of Washington, D.C. Safeway avoided the takeover in two ways. First, it settled with the Hafts by acquiring their shares at a price which left them with $100 million in profit and also paid them an additional $59 million to buy back from them rights to purchase stores in the Washington, D.C., area, which had been given to them originally. Then Safeway management went through a leveraged buyout under the auspices of Kohlberg, Kravis, and Roberts, buying back enough shares from the public to gain control of the Safeway corporation. The Safeway corporation then ended up with a debt of about $4.1 billion. Safeway has since embarked upon a program of closedowns and/or sales of stores in a few regions of the country. This included all 141 stores in the Dallas-southwestern states region, as well as a regional headquarters and distribution center. In smaller communities on the Eastern Shore of Maryland and Delaware, 8 stores were closed down. Other areas were also affected, and the number of job losses continued to grow. In January, 1988, the Kansas City Division, involving 3,400 employees, was sold in a local management LBO; workers who had been through one round of concessions in their previous contract negotiations had to go through another round. In March 1988, Safeway Stores in the Arkansas Division, including stores in Arkansas, Louisiana, and northern Texas, were sold in a local LBO; and 2,500 union employees were forced into substantial wage and benefit cuts in order to preserve their jobs.	9,500 jobs lost
	Lucky Stores, a western states food supermarket and general merchandise store chain, fought off a raid by Edelman and ended up in a much weaker financial situation. The Lucky Stores management retained control of their corporation but decided to liquidate all of their Gemco general merchandise stores in California	6,000 jobs lost

Unions Involved	Circumstances	Estimated Number of Jobs Lost
	and Arizona and concentrate on its food store business. The Gemco stores closedown caused the net unemployment of 6,000 out of 14,000 persons that had been employed in the stores; the rest had employment rights for vacancies in other stores owned by Lucky Stores under a union contract.	
	Both the Safeway Stores and the Lucky Stores contractions are a reaction to a larger debt burden which causes stores (or plants) that had previously been marginal producers of net earnings to become submarginal, because higher earnings are required to service the debt. In such circumstances, stores or operating units may be shut down or sold to people who have stores in the same locality or region or plants producing the same products. The latter may close down some acquisitions or reduce the size of the operation.	
	In February 1988, in order to stave off a hostile bid by the Hafts (trading as Dart Group Corp.), Stop & Shop stores enlisted the services of KKR to structure a leveraged buyout which was done successfully at a price per share of stock which added $1.4 billion in outstanding debt to S&S, which then sold 58 of its Bradlees department stores to help pay down the debt. Bradlees stores, employing 3,000, were closed down; and the stores leased to Hechinger Company, a hardware and housewares chain with stores in Maryland, Pennsylvania, and Virginia, who presumably would use the stores as added outlets in its chain; but Hechinger then decided the stores would compete with those already in its chain and sold the leases. There were 3,000 former Bradlees employees out of work.	3,000 jobs lost
	In January 1988, Grand Union, operator of 360 food supermarkets were spun off by General Electric of France through a leveraged management buyout. In March 1988, Grand Union sold its 52 Colonial/Big Star stores in Virginia and North and South Carolina to Harris-Teeter corporation, an adamant anti-union employer. Two thousand union members lost their jobs and their union contracts.	2,000 jobs lost

Unions Involved	Circumstances	Estimated Number of Jobs Lost
Glass, Pottery, Plastics and Allied Workers	Diamond Bathurst, which was a company with three plants, acquired three other firms (Thatcher Glass, Glass Container Corporation, and Chattanooga Glass Company). It then, in 1984, had a total of 22 plants with 7,883 employees. It closed eight of the plants and now has only 4,075 employees.	3,800 jobs lost
	Owens-Corning Fiberglas fought off a takeover attempt by the Wickes Companies, ~~It then went through a leveraged buyout engineered by~~ Kohl~~berg, Kravis, and Roberts~~ during which it bought back stock that cost about $3.5 billion. It ended up with a debt of $2.6 billion and a large cutback in operations, and the number employed was reduced by between 12 and 13 thousand.	13,000 jobs lost
	In April 1988, there was an attempted takeover of the American Standard plumbing fixture manufacturing company by Black & Decker, a manufacturer of hand tools and household electronics.	350 jobs lost
	American Standard embraced Kelso and Co. as a "white knight" to keep out Black & Decker, who was willing to retreat for related legal reasons.	
	The State of Delaware, in which American Standard was incorporated, had enacted a law that would greatly delay, if not wholly block, a hostile takeover attempt. It required the hostile suitor to obtain 85 percent of outstanding shares before he could assume control. Black & Decker sued in federal court to have the law declared unconstitutional on grounds that it violated the "interstate commerce" clause. The court ruled against Black & Decker, which then sold its share holdings to Kelso and withdrew. Kelso acquired enough shares in the market to gain control.	
	Before the Kelso "rescue," in negotiations with the union, the American Standard management had cited company assets totalling $3 billion and debt of $400 million. After the Kelso-management stock purchase, the debt had mounted to a staggering $2.8 billion, and the company had to borrow about $2.7 billion. In	

Unions Involved	Circumstances	Estimated Number of Jobs Lost
	October 1988, the company announced that it would close down the Wauregen, Connecticut, plant, where 341 employees were employed and would lay off about 16 salaried employees at a Tiffin, Ohio, establishment.	
Retail, Wholesale and Department Store Union	Gimbels Department Stores. In the 1970s, the Batus corporation, a British holding company, obtained majority control of the Gimbels Department Store operation, including its subsidiary, Saks Fifth Avenue. Batus held the property and allowed it to be operated as department stores until the real estate on which the Gimbels stores were located became valuable. Then it closed the Gimbels stores in late 1986, early 1987, to rebuild for other uses. (The most profitable Saks Fifth Avenue stores have remained in operation.)	5,000 jobs lost
	Jacob Suchard of Switzerland acquired Brock Candy and closed down one of the three plants.	160 jobs lost
United Rubbber, Cork, Linoleum and Plastic Workers of America	In 1986, Goodyear Tire & Rubber Company fought off a takeover attempt by James Goldsmith. Goldsmith walked away with $92 million in greenmail. To buy back his stock, and shares held by the public, Goodyear added $2.6 billion to its debt. It greatly reduced and then closed down operations at its Kelly Springfield Tire Company plant in Cumberland, Maryland, which had employed 800; and through forced early retirements and layoffs, also had a 600-person reduction of its headquarters staff; and then in 1988, induced another 438 in Akron, Ohio, and at tire plants elsewhere, to retire early.	1,800 jobs lost
United Paperworkers International Union	After Crown-Zellerbach's James River paper company was acquired by James Goldsmith in a hostile takeover, 1,000 employees were laid off in October 1985.	1,000 jobs lost

Unions Involved	Circumstances	Estimated Number of Jobs Lost
United Steelworkers of America	When Lykes shipping company took over the Youngstown Sheet and Tube Company in 1969, the head of Lykes announced that he would use the cash flow of Youngstown Sheet and Tube, about $100 million a year, as he saw fit. He proceed to do so, and one of the two Youngstown plants, the Campbell Works in Youngstown, an older plant, was allowed to run down. Instead of having equipment replaced, the Lykes company milked Youngstown Sheet and Tube. Youngstown Sheet and Tube also had another newer plant which was in good shape, and Youngstown Sheet and Tube assets were later sold to Jones and Laughlin, which then was merged with LTV. The latter closed the Campbell Works, which had employed 4,000. One subsidiary of an acquired firm, Endoro Products, had to be sold off for anti-trust reasons; and it went bankrupt, and 700 jobs were lost. In 1984, LTV also acquired Republic Steel, and it then closed more of its plants.	Total of 13,800. Estimated 13,100* of total of 109,000 work force reduction between 1971 and 1986 due to closedown of merger acquisition plants. Also, 700 jobs lost at Endoro Products after sell-off.
Amalgamated Clothing and Textile Workers Union	Pacific Holding Corp. through a leveraged buyout acquired Cannon Mills Co. in January 1982 for $413 million. After the acquisition, many mills were closed or sold. In January 1986, most of the remaining plants were sold to Fieldcrest, which closed or sold 4 mills. Employment decreased from 23,200 in January 1980 to 15,500 in December 1985.	9,200 jobs lost
	Tultex, Corp. acquired Washington Mills in July 1982 for $17 million; closed Marion, North Carolina, plant in November 1984.	500 jobs lost

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*Between 1971 and 1986, LTV closed a number of plants and dismissed 78 percent of the work force of the three acquired companies. Six other major steel companies reduced their combined work force by only 66 percent over the same period. If the additional 12 percent of the LTV reduction was attributed to the effect of excessive merger acquisitions, it would account for 13,100 of the dismissed workers.

Unions Involved	Circumstances	Estimated Number of Jobs Lost
	Dan River -- leveraged buyout by investor group for $154 million in May 1983; subsequently, plants employing 4,086 closed or sold -- employment reduced from 12,000 to 8,000.	4,000 jobs lost
	Cone Mills Corp. -- leveraged buyout for $420 million by members of existing management March 1984 -- when employment was 10,944; sold Union Bleachery plant in Greenville, South Carolina -- employment in November 1985, 10,000.	940 jobs lost
	TI-Caro, Inc. -- leveraged buyout for $190 million by members of existing management May 1984; plants sold off in Burlington and Graham, North Carolina, and closed a plant in Cleveland, Tennessee -- employment reduced from 5,700 to 4,700 by November 1985.	1,000 jobs lost
	Gold Mills/Saratoga/FFF by Guilford Mills --fired 350 employees at Saratoga when both Saratoga plants closed (1986).	350 jobs lost
	Cluett, Peabody & Co., Inc. merged into West Point-Pepperell January 1986 -- 10 U.S. plants sold or merged.	3,300 jobs lost
	Blue Bell, Inc. leveraged buyout (1984) for $470 million, then acquired on July 27, 1986 by VF Corporation. Employment reduced from about 20,000 to 18,800.	1,200 jobs lost
	Health-Tex -- leveraged buyout for $230 million in1985; closed three plants (1986-87).	1,300 jobs lost
	Levi Strauss & Co. -- leveraged buyouts for $1.7 billion by investor group -- sold many plants to meet payments incurred by the buyout.	5,200 jobs lost

Unions Involved	Circumstances	Estimated Number of Jobs Lost
International Chemical Workers Union	Granite City Steel bought out by National Intergroup and Nippon Steel in 1984.	250 jobs lost
	MK Laboratories of Fairfield, Connecticut, go bankrupt after LBO in 1988.	140 jobs lost
	American Salt LBO by General Host in 1988.	60 jobs lost
	Hilton-Davis LBO of Sterling Drug in Cincinnati.	300 job reduction
	Cities Services plant in Copperhill, Tennessee, 650 loss after Tennessee Chemical LBO in 1982.	650 jobs lost
	Dow bought Morton plant in Kanakee, Illinois in 1984 -- closed production; closed distribution center in 1988.	170 jobs lost
	Four original Harshaw plants in Ohio and Kentucky bought by Engelhard from Kaiser in 1988.	Cutbacks -- net loss of 390 jobs
United Auto Workers	General Motors sold TEREX Division to IBH Holding AG of Germany through an LBO in December 1980 after a struggle and bankruptcy; and TEREX acquired through second LBO by Northwest Engineering in 1987, and ceased operations shortly thereafter. Total job loss -- 2,800 workers.	2,800 jobs lost

TOTAL ESTIMATED NUMBER OF JOBS LOST: 91,160

HBS:ehb

1/25/89

Experience of the Fred Meyer, Inc. Company

This note is in response to Senator Packwood's request for an AFL-CIO analysis of a statement by Roger S. Meier entitled, "Let's Build Oregon: The Real Meaning of LBO," particularly with respect to the experience of the Fred Meyer company since it went through a leveraged buyout (LBO) in 1981.

While the numerical record of the growth of the Fred Meyer company is impressive, it has to be considered against the circumstances that prevailed when the leveraged buyout took place in 1981. Much of what follows in this analysis is taken from a 1986 article in the **Harvard Business Review** entitled, "No More Cozy Management Buyouts," by Louis Lowenstein who made a study of the Fred Meyer LBO. A copy of that article is attached; the detailed Lowenstein analysis of the Meyer LBO starts on page 150.

The financing of the Fred Meyer LBO was facilitated by a unique circumstance; namely, that the company owned the real estate on which the stores were situated as well as the stores themselves. To take advantage of this circumstance, the new ownership was divided between two newly established private companies. One of them, Fred Meyer, Inc. paid $200 million for the stores and merchandise and the other, Properties, paid $220 million for the real estate. Both corporations were owned by the same group. When the deal had been closed, the new Meyer company leased back the developed real estate from Properties. The new Meyer company did not have to sell off any of the operating divisions and was able to continue to earn profits from all the stores. As a result, a hiatus in new store openings was relatively brief. Although prior to the LBO the company had opened stores at the rate of about two a year, none were opened in 1981, the year of the buyout; two were opened in 1982; and one in 1983. These additions to the 64 previous stores helped boost 1983 sales by 6.6 percent even though the gross profit margin and operating expense ratios remained constant.

It should be noted that the senior management group of the old Fred Meyer company remained intact. The two top executives and the nine top staff people, who had owned 1.6 percent of the old company shares, owned 9 percent of the new Meyer company shares. Nevertheless, they made only a nominal cash investment. Of the 1.5 million shares made available to the management group, it had to buy only 398,000 at a price of $4.00 per share, with the balance held subject to stock options at the same price. Even for the shares immediately purchased, all but $3,000 was paid in the form of notes payable in installments beginning five years after the closing. Thus, senior management invested almost no cash for the $5.5 million worth of stock and stock options that it received.

The management group made a much more substantial investment in the Properties company, altogether, about $3.8 million, including $2.1 million in cash. Most of the new money invested in the new Meyer company consisted of $175 million of debt obtained from lenders at varying interest rates, and there were total equity investments of $54 million. Consequently, annual interest expense grew from $1 million in fiscal 1981 to $29 million in fiscal 1983. There were also higher rental expenses, because of leases entered into with Properties. Nevertheless, because the entire operation continued to function, there was a sufficient cash flow to resume a rapid store expansion program that had been characteristic of the old Meyer company. Such expansion -- before and after the

LBO -- was due in good part to a formula combining food and general merchandise goods in very large stores. It fitted population distribution, residential mode, and life-style of the Pacific Northwest, and thereby created a unique market niche.

Two conclusions emerge from the experience of the Meyer LBO. It was a unique situation because of the ownership of the underlying real estate by the company, which permitted the whole deal to be done with less cash financing than would have been required if all or many of the stores were under leases from other owners, as is often the case in retail operations. If the LBO had not occurred, there probably would not have been a hiatus and two- to three-year slowdown in expansion and openings of new stores, there would not have been the need for a few million dollars in cash payments to management stockholders, and the expansion of the Meyer store chain would have proceeded at a somewhat more rapid pace.

Roger Meier's communication also had some general comments about LBOs which ended with a conclusion that, "They add significant value to the nation's economy." We disagree with this conclusion. Top management remained unchanged. There was a significant addition of new debt which required interest payments that drained part of net income that could have supported greater new investment. There was a separation of property capital from operating capital that removed part of the underlying strength for operations.

HBS:ehb

2/6/89

Attachment

This is a supplement to our earlier response, "Experience of the Fred Meyer Company, Inc." to Senator Packwood's request for an analysis of a statement by Roger S. Meier entitled, "Let's Build Oregon: The Real Meaning of LBO."

During the hearings, Senator Packwood also raised some specific questions about the aftermath of Fred Meyer experience following the LBO. The questions and our answers are as follows:

1. Did they drop out of the bargaining unit? No, they did not drop out of the bargaining unit. As Senator Packwood indicated, they are still unionized.

2. Have there been give backs? There have not been give backs. At the time of the LBO, Fred Meyer asked for some concessions, but no concessions were given and the matter was not pursued. At that time, there were some wage freezes in some areas in which the Meyer stores were located. They are still in the multi-employer bargaining unit.

As we had pointed out in the earlier submission for the record, the Meyer LBO was a unique situation because of the ownership of the underlying real estate of the company which permitted the whole deal to be done with less cash financing and, therefore, less borrowing than would have been required if all or many of the stores had been under leases, as if often the case in retail operations. Without the large buildup of debt that often accompanies an LBO, it was possible with only a brief hiatus to continue the expansion of the Meyer chain.

HBS:ehb

2/13/89

A Review of the
"Presentation on Leveraged Buyouts"
by Kohlberg Kravis Roberts & Co.

This submission for the record is in response to the request of Senator Danforth for a review of the Kohlberg Kravis Roberts & Co. report, "Presentation on Leveraged Buy-Outs."

The January 1989 "Presentation on Leveraged Buy-Outs" provides a description of Kolhberg Kravis Roberts' leveraged buyout (LBO) experience that is tailored to show it in a favorable light, regarding various aspects of the public interest. However, a reading of the report raises questions about the accuracy and presentation of some of the material, and about some of the reasoning.

As a general matter, except for certain information with respect to taxes and debt, the data provided relate only to companies over which Kohlberg Kravis Roberts have retained ownership. It is stated that Kohlberg Kravis Roberts attempted to get data with respect to operations that it had sold, but concluded that such information was not sufficiently verifiable and could not be used. Therefore, most of the information in the report concerns only 17 of the 31 companies that became privately held operations as a result of Kolhberg Kravis Roberts leveraged buyouts. There is no way of knowing from the report what actually happened with the 14 companies that had been acquired and then sold off. Couldn't KKR provide information, at least, on what happened to the 14 companies while they were under KKR stewardship? In fact, with the vast resources commanded by KKR, couldn't it have obtained the necessary information to present a complete picture? Was employment increased or decreased during Kolhberg Kravis Roberts ownership, and what was the condition and employment experience of the companies shortly after they were sold by Kohlberg Kravis Roberts?

A question about the accuracy of information presented in the report arises before a reader gets very far. On page 1-3, it is stated that Safeway Stores, a 1986 acquisition of KKR, operates approximately 2,170 supermarkets and other types of grocery stores, and several other specialty retail food stores in the United States and Canada. On page 6-1, in dealing with employment, it is indicated that 1,273 Safeway Stores were operated in 1984, and 1,155 stores were operated in 1988.

A general question is raised on page 4-1 of the report: "What is the effect of leveraged buy-outs on employment?" It is claimed that "as a general matter" leveraged buyouts do not result in layoffs of employees. In support, it is stated that employment at KKR-owned companies had increased from 276,000 in the LBO year to 313,000 three years after the LBO. An example is cited that 100,092,000 man hours were used in 1984 to operate 1,273 Safeway Stores, and 118,000,000 man hours were used in 1988 to operate 1,155 Safeway Stores. The LBO year for the Safeway acquisition, shown on page 1-3 of the report, is 1986, so the comparison with 1984 doesn't illustrate what happened from the LBO year to three years later. Furthermore, union records show that 86,745 people at Safeway are presently represented by the union as compared with over 100,000 prior to the LBO. We are not aware of any nonunion expansion by Safeway.

As indicated in the attachment to my testimony of January 26, we estimate that 9,500 jobs were lost as a result of the wholesale closedown and/or sale of stores in different parts of the country. Additional job losses also occurred because at least one regional headquarters and distribution center were closed. There also has been a resort to increased part-time employment, which does not help an employee that has a family to support.

Recently, following a KKR acquisition of the Stop and Shop company which owns food supermarkets and the Bradlees department store chain, there has been a liquidation of merchandise and the closedown of a few dozen department stores which had led to the loss of a few thousand jobs.

The main aspects of the Kohlberg Kravis Roberts report are treated in Section 4 under the heading about "answers to some general questions about leveraged buy-outs." The first couple of questions are: "Do leveraged buy-outs result in more or less tax revenue to the Internal Revenue Service?" "Are leveraged buy-outs tax motivated?" It is then claimed that taxes paid to the federal government as a result of leveraged buyouts exceed taxes that would have been paid if no buyout had occurred. One of the major supports for this claim is that "the same interest payments which give rise to tax deductions by the interest payer are taxable to most of the recipients." This generalization overlooks a few facts.

(1) First, there are major investors in debt securities that pay no taxes on interest payments received. These include pension funds, religious organizations, charitable organizations, and private educational institutions. Others, such as insurance companies, operate under rules that permit tax deductions for losses and pending losses, so that they do not pay taxes on all interest received. (2) A substantial portion of payments to the recipients of interest, particularly financial institutions, have a cost of funds to them which is likely to absorb most of the interest they receive. They pay interest on the funds they obtain and, therefore,

would pay taxes on only a small portion of the interest received from a borrower, such as KKR. (3) Nonfinancial corporations may also have losses to offset against interest income payments received. For example, some of the nonfinancial corporate investors and wealthy individuals, who recently acquired savings and loan associations with large losses on their books to offset earnings, will not be paying taxes on interest payments received.

Furthermore, if LBOs had a lower ratio of debt to total financing, they would pay more taxes on earnings. The government would borrow less, and more funds would be available for lending for other purposes. Resultant lower interest rates would then encourage more investments and also would reduce the drain of consumer income for interest payments because of lower rates on home mortgages, consumer credit, and on outstanding adjustable rate home mortgages and home equity loans.

Also, if firms that have been acquired through LBOs paid more taxes on earnings because of less debt financing and interest payments, other interest recipients would be available to absorb the loanable funds, albeit at a somewhat lower rate; and these borrowers with a lesser debt-to-equity ratio would pay more taxes, although the lenders -- that is, the recipients of their interest -- would pay taxes for a second go round of net interest income received.

Another major question is, "Can management buy-outs withstand downturns in the economy and other negative events?" Experience is cited that KKR had arranged 13 leveraged buyouts from May 1976 to December 1982 and all of these buyout firms were owned by KKR through the recessions to the early 1980s when the prime interest rate rose to over 20 percent. Most of these earlier KKR buyouts had not been leveraged with as great amounts of borrowed funds as those that came later, and other entities in the economy -- including the government, consumers, and financial institutions -- were then in much better financial shape than currently. There was much less danger than today of a drastic credit crunch which could lead to a severe recession and the insolvency of heavily indebted corporations.

KKR presents one case of a machine tool manufacturer which it had acquired through an LBO in 1979, Houdaille Industries, that ran into serious difficulties in the early 1980s, as an example of an LBO firm able to withstand economic adversity. In addition to the high interest rates during the 1981-82 recession, Houdaille came under severe competition from Japanese producers with regard to the machinery and other products that it manufactured, and the recession itself led to reduced demands for many products. The company liquidated two plants that produced chrome-plated automobile bumpers that were losing their market to new plastic and rubber bumpers. Construction materials and contracting businesses which were low-margin operations (underlining added) were sold, as was a power transmission equipment business, and some other product manufacturing operations were disposed of. (The need to sell or discontinue operations that had been marginal but become submarginal under an increased debt servicing load following an LBO is a result that follows after many LBOs.) The company also sold two machine tool operations and closed two others that were no longer profitable.

The Houdaille company had been acquired by KKR in late 1978. Although the stock had traded for as low as $14.50 per share in 1978, on October 25 of that year KKR offered to buy the stock at $40 per share. However, $60 million in bank borrowing had been used to accomplish the buyout. Ten years ago that was a heavy debt, and operations which had been low-margin but sustainable became submarginal and had to be sold off. The KKR report presents the survival of Houdaille as an example of successful financial survival of an LBO. There is no mention, however, of what happened in the employment situation in Houdaille as various divisions that became submarginal were closed down or sold off. Apparently, significant unemployment relative to the size of the company was being generated.

Section II of the report presents diagrams showing how in several KKR LBOs (Beatrice, Safeway, Owens-Illinois, and Jim Walter), the bank debt outstanding (underlining added) was reduced much sooner after the LBO than had been projected. The report does not say, however, how this was accomplished. This is accomplished, in part, by selling off various parts of the acquired company. This was certainly done in the cases of Beatrice and Safeway. Another avenue to reduce debt owed to banks is by replacing it with other debt. Generally, a great deal of bank borrowing is done in connection with the initial acquisition of the equity shares for the leveraged buyout. Funds to repay the bank debt are then obtained by issuing various types of bonds for longer maturities than the bank loans. These bond financings will be outstanding for a number of years. The issuance of additional debt, first in the form of bank loans and then in the form of longer term securities, decreases the market value of previously outstanding bonds which are owned by life insurance companies, pension funds, and other long-term investors of funds being administered on behalf of workers and insured persons. Life insurance companies currently are suing KKR because of the decline in the market value of older RJR Nabisco bonds that they are holding. To the extent that pension funds are holding such bonds, it has put at increased risk the retirement income of many workers.

The KKR report completely omitted any mention of the fees that it makes through its activities in connection with the LBOs. An article in the **Wall Street Journal**, February 1, 1989, reports that KKR&Co. said it will reap a one-time fee of $75 million for arranging its record $25 billion leveraged buyout of RJR Nabisco, Inc. KKR earned fees of $60 million each for the buyouts of Safeway Stores corporation and Owens-Illinois corporation whose price tags were $4.5 billion and $3.8 billion, respectively, and $45 million for its $6.2 billion buyout of Beatrice companies. KKR's standard fees also include a 1.5 percent management fee for its buyout funds, plus 20 percent of any profits from successful LBOs.

The danger to the economy from the gigantic LBOs does not stem from the fees earned by KKR and others who work in the LBO occupation; it stems from the dangers to the economy which have been indicated in the foregoing analysis of the KKR report. However, the fees that can be earned are undoubtedly incentives for people to engage in the LBO activities, which are facilitated by unlimited deduction from taxable income of amounts equal to interest payments on debt incurred in LBOs.

Nothing useful is produced through the LBO restructurings which greatly increase the amount of outstanding debt owed by individual companies and the aggregate outstanding in the economy. It makes the individual firms and the entire economy more vulnerable to a contraction preceded by higher interest rates and followed by reduced purchases.

HBS:ehb
2/7/89

No more cozy management buyouts

It's time we see MBOs
as they really are
and make the buyout process
more open than it is

Louis Lowenstein

The excitement surrounding stock market takeover activity in general, and the phenomenon of leveraged buyouts in particular, has built through the 1980s. Shareholders are, of course, making a great deal of money in these buyouts. But, more than that, much of the activity is seen by some as part of a new entrepreneurial wave sweeping the nation, expressed perhaps most poetically by the image of long-anxious would-be entrepreneurs taking charge of their own businesses and thus finally making their own decisions.

Not so, says this veteran observer, who believes the proponents of buyouts are simply putting sociological icing on what is a very financial cake. From his study of 28 buyout proposals, and his detailed analysis of one in particular, the author paints a different picture of the history of management buy outs, draws some controversial conclusions, and ends with a proposal for correcting the situation.

Mr. Lowenstein is professor of law at Columbia University, where he teaches corporate finance. From 1978 to 1979, he was president of Supermarkets General Corporation, and before that he was engaged in corporate law, and mergers and acquisitions practice with the New York City law firm of Kramer, Levin, Nessen, Kamin & Frankel. He has extensive buyout experience as counsel for a leading leveraged buyout banking firm.

When managers first began to buy back the stock of their publicly traded companies and take them private in the early 1970s, their shareholders cried that such "management buyouts" were freezing them out at bargain basement prices. As time passed, and as shareholders began to join in the spoils of what became intense bidding wars (in which the value of their shares could rise as much as 50% or even 100% almost overnight), their hue and cry turned to applause.

Now management buyouts (MBOs) have become a stock market game which nearly everyone seems to be winning, whether the managers buying their own businesses, the shareholders watching their stock prices climb, or the investment bankers overseeing the process. Has anyone stopped to ask how that is possible? Is it ever really possible for *everyone* to win? Or how a group of managers – and their buying consortia – can pay so much?

My study of Fred Meyer, Inc. – a company that went public, went private, and tried to go public again – and of 27 other recent buyout proposals valued at more than $100 million shows that tax breaks explain much of the pricing of management buyouts. All of the deals included large interest deductions, and, depending on the company, aggressive write-ups and accelerated depreciation of asset values, and the adoption of an employee stock ownership plan (ESOP). Each of the ingredients is familiar, but the distinctive result of combining them in MBOs is that managers can, with suitable backing, purchase the business from the public and finance much of the price out of tax-generated cash flows. (See the insert for definitions of terms.)

Productivity improvements might be expected from the managers' much increased equity stake in the venture and their ability to operate the

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Author's note: This article is based on my earlier work, "Management Buyouts," *Columbia Law Review*, May 1985.

business free from some of the more invidious pressures of the public market. But there are offsetting negative factors. Out-of-pocket costs can easily total $10 million to $30 million or, if there is exotic, junk bond financing, even more. The managers frequently take down large cash sums at the time of the buyout, perhaps reducing their motivation as well as their risk. Debt-equity ratios of 4-1, 6-1 and even higher may put a useful, cash-hungry wolf at the door, but they also limit flexibility.

However these plusses and minuses add up, the newly private companies are inherently unstable marriages of convenience. In three to five years, after the acquisition debt has been paid down and the managers have fulfilled their contractual commitments, everyone – managers, investment bankers, lenders, and investors – feels powerful pressure to sell the company, either as a whole to another company, or in part to the public. Almost as quickly as it began, the recently rejuvenated team of just a few years earlier will have ended its brief day in the warm sun of private, entrepreneurial ownership.

MBOs are largely another form of financial transaction with suspiciously little social value. It's more than a question of taxes. Even if we amend the tax law, issues of fiduciary responsibility will remain. Certainly the 1981 and 1984 tax changes made buyouts more attractive, but they existed before then. Even though bidding wars can give shareholders a portion of the tax benefits, managers are more frequently taking steps to preempt the bidding and protect the deal as well as their jobs. Public shareholders are still at risk. Insiders choose the timing of the buyout and can take advantage of important differences in the way the stock market, with its very high turnover rates, fixes the prices of the shares of a company and the way it prices the company as a whole. The temptation to profit from these differences, as well as to depress if not manipulate reported earnings or stock prices, is continuing and compelling. It's time we reappraised MBOs; this article will show how and why.

Past & present MBOs

Management buyouts came about for a number of reasons. The first were changes in state law. From the 1920s to the 1960s, a number of states adopted statutes modifying earlier rules that prohibited transactions with interested directors. The states also facilitated mergers by reducing the percentage of shares required for approval and permitting the payment of cash alone for the shares of the acquired corporation. The most immediate cause of the MBO, however, was a major bear market. After rising to 1,036 in 1972, the Dow Jones Industrial Average dropped almost in half to 578 in 1974. A substantial number of small companies that had gone public in the new issue market of the 1960s found their stocks selling at particularly depressed prices.

Having only recently ventured into public waters, the top executives of many of these companies still owned controlling or even majority interests. Many, finding that the public waters were not fine, decided to return to the quiet shores of private life.

They were widely condemned. Public shareholders had been frozen out before, for example, when a parent operating company eliminated the minority shareholders of a publicly owned subsidiary. The market tolerated these parent-subsidiary mergers, however, because they sometimes eliminated conflicts of interest in intercorporate transactions or helped achieve operating efficiencies. By contrast, the MBO seemed like a purely internal or financial rearrangement. Management used the company's resources, credit, and, when necessary, its proxy machinery to eliminate all public ownership – ownership that the management had only recently offered to the public at much higher prices.

While these earlier MBOs violated an old and useful taboo, they had trivial direct economic consequences. The companies were remarkably small. According to one study, the mean market value of all the publicly held shares of 45 companies that made going-private proposals and that were also listed on the American or New York Stock Exchange was less than $3 million.[1] In the mid-1970s, no one would have guessed where the MBO would go.

More & more MBOs

The $1 billion buyout of the mid-1980s has replaced the $3 million buyout of the mid-1970s. According to W.T. Grimm & Company, the total annual dollar volume rose from less than $1 billion in 1980 to $7 billion in 1983 and more than $11 billion in 1984.

Moreover, the market no longer perceives MBOs as something shareholders should fear. *Forbes* often studies potential MBO candidates so that, it once suggested, its readers can be among "those lucky investors who happen to be in the right place."[2]

What has changed? Faced with an officer's proposal to take the company private, public shareholders still have no collective will and cannot negotiate an alternative proposal. The timing of an MBO and its price are still suspect. Because the companies are now so large, however, top management can no longer hope to own a controlling block of stock.

Competitive bidding becomes possible. Unlike Mary Wells of Wells, Rich, Greene, Inc., whose famous proposal to take her firm private angered then SEC Commissioner Sommer in 1974, it is not founders but professional managers who now make the bid. The CEO of Esmark owned less than 1% of that company's shares when he made his buyout proposal.

The larger the company, therefore, the more likely an MBO proposal will trigger an uninvited third party offer and set off a reasonably good auction. Allowing for an occasional exception where the insiders do own a controlling interest, they can no longer preempt the bidding. MBOs have in effect merged with the recent market for hostile takeovers.

In the Stokely-Van Camp MBO proposal, the principal shareholder-officer (who owned about 14% of the outstanding shares) offered a price of $50 per share compared with $38 before the announcement. Under the threat of a competing offer from Esmark, he raised the price to $55. Pillsbury, however, bid $62, and Quaker Oats ultimately won the bidding contest with its offer of $77 per share – fully 40% more than the top price bid by management. In short, whether insiders or outsiders win the bidding, the public shareholders have much less reason to fear that they will be shabbily treated in an MBO.

The MBO market has become increasingly institutionalized. For many corporate presidents it is a rare week when investment bankers, known and unknown, do not call to propose that their company be the chosen instrument for an MBO. Large pools of capital are available and the market has become very competitive.

How can the bids be so high?

The results of the study of 28 management buyout proposals, made from 1979 to 1984 and ranging in value from the $101 million bid for the Bekins Company to the $2.5 billion transaction for Esmark, are grouped in the *Exhibit*. All 28 transactions were consummated either as MBOs or as third party sales.

The data clearly show that companies going private are now often large and that their managers no longer own controlling blocks of stock. After going private, management's percentage ownership in the new company, while still not a controlling interest, rises significantly. For the small group of executives permitted to participate, MBOs remain an attractive vehicle.

Exhibit **The group of 28**

Size and shareholders

	Company value in millions of dollars	Management's percentage of outstanding shares	
		Target companies	Fifteen new companies*
Median	$ 401	3.8 %	10.4 %
Mean	496	6.5	24.3

Premiums paid

	Premium of winning bid over market price 30 days before first significant announcement			Disclosed number of actual or potential bidders†	Premium of 11 successful third party bids over management bid
	All bids	Fewer than 3 bids	Three or more bids		
Median	58 %	48 %	76 %	2.0	8 %
Mean	56	30	68	2.5	14

Prices to earnings

	P-E ratio of winning bid to trailing four quarters' earnings	Three-year average P-E ratio	
		All 28 companies	Standard & Poor's "500" stock index
Median	17.1	10.0	9.8
Mean	20.3	13.1	12.3

*Excluded are two new companies, largely financed by ESOPs; the percentage ownership of the management group was far more than 20% but was difficult to calculate precisely.

†The number of actual or potential bidders was based on the company's disclosure documents and included those who did no more than hold general discussions or file a Schedule 13D.

Where the number of competing bids was three or more, the median premium over the preannouncement stock prices was 76%, and even where the number was less than three, the median premium of 48% was remarkable. Auctions, and even threats of auctions, help. The advantage to the selling shareholders of competitive bidding is underscored by the median 8% and mean 14% premiums paid by success-

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1 Harry DeAngelo, Linda DeAngelo, and Edward M. Rice, "Going Private: Minority Freezeouts and Stockholder Wealth," *Journal of Law and Economics*, October 1984, p. 367

2 Steven Kichen and Leslie Pittel, "Selling High," *Forbes*, May 21, 1984, p. 248

ful third party bidders over management bids that already include a healthy premium. Assuming that the management bid was 50% over the preannouncement stock market price, the shareholders gained a median 12% and mean 21% additional premium over the market price if their managers didn't win. Not only would the 58% median premium be significant in the worst of market times, but in this, the 1979 to 1984 period, it is remarkable.

As the *Exhibit* shows, the stock market was not notably depressed at the time these bids were made, nor were the 28 stocks depressed relative to the market as a whole. Whatever the explanation, it seems clear that the shareholders of a company going private are no longer the pitiable lot they once seemed. A coercive element does remain; the public shareholders will be eliminated, if not by one buyer, then by another. But at some point the issue is price, and at some price the shareholders will not care whose money they take.

While the data show that buyout prices are higher with an auction than without, they do not demonstrate why prices are so high on an absolute scale. Can bidders pay a median of $17 and a mean of $20 for each dollar of earnings they buy and still hope to show a profit?

Old explanations for the premiums paid seem feeble at best. A billion dollar company does not go private to save legal fees and the other routine expenses of having publicly traded securities. The fees and expenses of the Malone & Hyde MBO (an estimated $16.5 million) would pay for a generation of compliance costs.

Moreover, it is unlikely that the managers of large, better known companies have systematically hidden information about earnings and prospects or have depressed their stock price or reported earnings, simply to go private. Of course, such possibilities are real. And the MBO's increasing acceptability may open up new and more troublesome avenues for managerial manipulation.

But for now, many of the companies seeking to go private are both well managed and open to security analysts. Companies like Esmark and Metromedia tried to maintain rather than disparage the value of their shares. Still others have turned to an MBO as a final defense against a hostile shareholder or tender offer; they obviously had not been trying to understate their earnings or expectations.

Shopping for real gains in a supermarket?

Until recently, efforts to analyze the effects of an MBO were largely a matter of speculation. Once the company went private, it was impossible to know what later transpired and, therefore, difficult even to know what had been contemplated. Fred Meyer, Inc., however, is one of a growing group of companies in which a management buyout was shortly followed by a public offering. A public offering by a company that has only recently gone private may seem quixotic. It shows that MBOs no longer arise from the wishes of owner-managers simply to complete their ownership of the business and dramatizes just how much the game has changed.

Fred Meyer, a well-established retailer of food and general merchandise, is a particularly useful company to examine in detail. The business is not complex, and any managerial innovations should be quickly reflected in the operating results. Because the estate of the founder and other affiliates held 38% of the outstanding shares, it is unlikely that the established management group manipulated the stock price or the reported financial results.

The investment bank was Kohlberg, Kravis, Roberts & Company, a leader in the field. The terms and structure of the issue seem to have been typical rather than anomalous. Among the companies I studied, Fred Meyer is close to the median with respect to its market value as a whole, and also with respect to its price-earnings ratio attributed to the company's earnings both in the marketplace before the offer and in the winning bid. Even though an analysis of any one buyout cannot suggest conclusions as to what is typical, it does indicate what is feasible.

The original Fred Meyer (Meyer) was an Oregon corporation and had total annual sales of just under $1 billion in fiscal 1982. Before Kohlberg, Kravis's September 1980 announcement of interest in acquiring Meyer, its common shares traded at about $28.81, equal to about eight and one-half times actual earnings for the current fiscal year 1981 (about the same as that of other retailers and that of the leading indices). For fiscal 1981, the return on equity was 16.5% and the return on sales, 2.7%, both commendable.

The management buyout closed in December 1981. Meyer's shareholders received $55 per share – about 2 times book value, 1.92 times the 1980 preannouncement price, and 17.9 times the company's earnings. The total cash purchase price was $420 million, excluding debt and other assumed liabilities. A new Fred Meyer, Inc. (New Meyer), based in Delaware, purchased all Meyer operations and assets except the real estate, which was bought by a newly formed partnership (Properties). New Meyer paid $200 million of the purchase price and Properties paid $220 million. Both were owned directly or indirectly by the same group, albeit in somewhat different proportions. At the closing of the deal, New Meyer leased back the developed real estate from Properties.

What happened to the executives?

The senior management group of Meyer remained intact. The top nine people had been with the company since 1976 and the top two executives since 1947. Senior management had owned 1.6% of Meyer's common shares; on a fully diluted basis it owned 9% of the shares of New Meyer. Even so, it had to make only a nominal cash investment. Of the 1,500,000 shares to be beneficially owned by management, it had to buy only 398,000 at a price of $4 per share in December 1981, with the balance held subject to stock options at the same price. Even for the shares it did purchase, all but $3,000 was paid by delivering notes payable in installments beginning five years after the closing. Thus senior management did not have to reinvest in New Meyer any meaningful portion of the $5.5 million it had received in cash for stock and options in Meyer.

Special arrangements for management did not stop there. As a result of the proposed 1983 public offering, senior management would have incurred additional tax liabilities of about $2.5 million. According to the prospectus, "in order to alleviate the adverse financial consequences...[of] borrowing from traditional lenders," New Meyer agreed to lend them that sum payable without interest over ten years. Also adopted was a supplemental cash payment plan that would result in an aggregate $3.5 million paid out over a ten-year period.

Since the senior officers did invest about $330,000 as general partners and $3.5 million, of which $2.1 million was in cash, as limited partners in Properties, their cash stake was higher in the company that did not need their skills. Their stake in Properties created a conflict of interest when management finally asked the public to buy shares in New Meyer, which was under common control with Properties. The terms of all existing leases between Properties and New Meyer were to be renegotiated in 1987. Properties also owned other sites New Meyer had scheduled for future development.

What operating improvements were made?

No significant improvements in the Fred Meyer operations seem to have occurred as a result of the buyout. Was the management distracted by the very fact of the buyout? Perhaps. In the past, the company had opened stores at the rate of about two a year. None were opened in 1981, the year of the buyout, two were opened in 1982, and one in 1983. In fiscal 1983, sales were up 6.6% but for the first time in many years no increase occurred on a sales per square foot basis. Gross profit margins (about 27%) and operating expense ratios (about 21.5% apart from rentals) both remained constant.

While the buyout produced no significant improvement in Fred Meyer operations or profitability, the financing of – and accounting for – the transaction had a big impact:

☐ The new money invested in New Meyer consisted of $175 million of debt from institutional lenders at varying interest rates and $54 million of equity. As a result, interest expense (excluding interest on capitalized leases and mortgages) grew from $1 million in fiscal 1981, Meyer's last full fiscal year, to $29 million in fiscal 1983, New Meyer's first full year.

☐ Since New Meyer no longer owned the real estate used in its operations, it incurred higher rental expenses because of the operating leases entered into with Properties. Store operating expenses rose 155% from $16 million (1.7% of sales) in fiscal 1981 to $41 million (3.7% of sales) in fiscal 1983.

☐ Because New Meyer paid so much more than the book value or tax basis of the acquired net assets, it could appraise the inventory and other assets at much higher figures, thereby increasing such deductions as cost of goods sold and depreciation for tax purposes. Inventory values alone rose by $46 million, an amount much more than Meyer's LIFO reserves.

No more than $9 million of the New Meyer purchase price was allocated to goodwill or other intangible assets that could not be amortized for tax purposes. (It is often thought, though less often said, of course, that the appraisers hired by new companies to value the acquired assets sometimes manage to confirm values substantially in excess of what they could be sold for in separate transactions. It is widely assumed that the Internal Revenue Service lacks the manpower to audit any significant portion of these transactions.)

☐ The effect of these changes, none of which had any impact on operations, was to put New Meyer in a net loss position for tax purposes for an indeterminate period of time. By January 29, 1983, the company had accumulated $13 million of net operat-

Glossary MBO & LBO

To focus on those transactions where there is a significant conflict of interest, I have used the term "management buyout," or MBO, to mean the purchase for cash (or nonconvertible senior securities) of substantially all the assets of a public corporation in a transaction in which members of that corporation's management acquire a significant equity interest in the purchaser, and the purchaser is closely held and has not theretofore been an operating company or a subsidiary of one. Usually the purchaser's financing consists largely of borrowed money, hence the term "leveraged buyout," or LBO. That term, however, is also used to cover buyouts of mere subsidiaries or divisions of a company. These divisional divestitures are of less concern because the managers of the parent company are not on both sides of the table.

ing losses and $2 million of unused investment tax credits for tax purposes and continued to show losses on a current basis. These losses were not simply a consequence of an allocation of revenues between New Meyer and Properties. In 1982, Properties distributed $7 million in cash to its partners (including senior managers) and in addition generated federal income tax deductions for them of $10 million.

The overriding sense is that nothing much happened in the Fred Meyer buyout, at least nothing representing real gains in asset utilization. Yet the most experienced banking firm in the leveraged buyout business paid a premium of 92% over the market price. At the time, much was made of the fact that Meyer's real estate was carried on the books at prices well below market value. If the real estate could have been used more profitably, however, the new owners would presumably have sold a substantial part of it. Two years after the buyout, the only store scheduled to be closed was one old, undersized unit.

Given the large transfer payments to the new investors and lenders, the cash flow of New Meyer was negative for fiscal 1983 and 1984. The proposed public offering in late 1983 seems to have been less an act of celebration than of prudence. Incidentally, the new issue was not consummated – perhaps because the new issue market weakened or because of the unresolved conflict of interest.

The lack of change in operations should not surprise us. Meyer was successful before the buyout, and an aging management team was not likely to innovate. What was surprising, however, was the utter absence of any personal risk for senior management.

The Fred Meyer case demonstrates the difference between the theory of management buyouts and its reality. The original theory was that the executives could make their fortunes if the new venture succeeded, but that at the same time they should put their personal fortunes at risk, even to the extent of mortgaging their homes. As time goes on, and as the competition for management's favor escalates, we are seeing rather more carrot and less stick. That was true in the Fred Meyer buyout. It was true, too, in the Malone & Hyde example, also a Kohlberg, Kravis venture, where top management again received very favorable treatment, invested no personal cash in the new business, and benefited personally – not from the price to the public shareholders but from a competition between banking firms. And the same happened in the buyouts at Cone Mills, Wometco, Metromedia, Brooks Fashions, and other deals: the executives took out cash from the old business and reinvested only a minor portion in the new, even while increasing their equity stake. Gresham's Law is always at work: the executive group in each new buyout reads the proxy statements of the earlier ones and does not want to settle for anything less.

Truffles, anyone?

Some financial economists have argued for what I like to call the truffle theory of buyouts: we need to offer management buyout opportunities if we are to obtain the truffles that the executives do not have sufficient incentive to root out as mere salaried employees of public corporations. For these economists, a terrible tension exists between fairness to the shareholders and economic efficiency. These economists would resolve the tension by allowing managers the lion's share of the gains, thus enriching society as a whole, while ensuring a Pareto optimal result because the shareholders, by not getting less than the market price, are not worse off. If this disproportionate sharing seems inconsistent with the rights of shareholders as owners of the business or with management's fiduciary responsibility, economists neatly resolve the inconsistency by asserting that the shareowners actually do not own anything but are mere contractors of capital – not very different from bondholders.

The facts of the Fred Meyer case – and those of the other MBOs I've studied – throw cold water on the assumptions that truffles are in short supply and that if shareholders eat even a modest share, there may be too little left to induce managers to act, with the result that the truffle supply will dry up for everyone.

In fact, MBOs are a game that all the participants have been winning. The shareholders in the 28 deals won a median gain of 58% over the preannouncement market price. The managers won immediate cash plus a much-enhanced equity stake in the new company at a bargain price. The investors brought together by Kohlberg, Kravis in Fred Meyer and other buyouts won average annual returns of 50% or more. The commercial bankers received above market returns – whether as interest, fees, or as an equity participation. The investment bankers won in so many different ways that we need a scorecard:

Equity interests in the new company

Fees for putting the deal together

Fees for advising the portfolio companies

Fees for watching over the pooled funds of their investor-clients before the funds were committed to buyouts

Fees as a share of the profits of the pooled funds after they were committed

Fees as directors of the portfolio companies

Truffles from the taxman

If management buyouts are often internal or financial rearrangements in an otherwise unchanged business, where do such large profits come from? The most visible – and most easily quantified – source is the tax benefits; MBOs eliminate federal income taxes for the corporation and, as in the case of Fred Meyer, may create generous tax deductions for individuals as well.

Much depends on the characteristics of the particular transaction. Will it be possible to write up assets? Or will such a write-up generate excessive tax-recapture payments on machinery and certain other types of assets for which management took accelerated depreciation and investment tax credits in the past?

There are, of course, tax costs as well as savings in the best of worlds. The public shareholders of the target company, but not necessarily the management, will generally incur a capital gain tax, and the interest deductions for the new company will be offset in part by taxable income to the lenders. The net saving is a function mainly of the difference between the 46% rate for corporate income on the one hand, and the lower long-term capital gain rates and the largely tax-exempt status of the lenders on the other. The individual varieties of tax savings created by an MBO are not novel. But in combination they enable the new company to operate tax-free for as long as five to six years – about the time required to reduce debt to the point where it is no greater than shareholders' equity. As Warren Buffett said, "If you can eliminate the government as a 46% partner," the business will be far more valuable.

The particular sources of the tax savings vary with the transaction. First, the interest deductions are always important. Their availability is subject only to very modest limitations in the Internal Revenue Code. Second, if as in Fred Meyer the purchase is at a substantial premium over book value, it will often be feasible to write up assets to values much above the depreciated values on the seller's books. Third, the new Accelerated Cost Recovery System, part of the Economic Recovery Tax Act of 1981 (ERTA), permits deductions for equipment and real estate over dramatically shorter periods of time.

ERTA, which was amended slightly in 1982 and 1984, is especially valuable in LBOs because it covers the purchase of used as well as new property, regardless of when it was first placed in service. While some of the benefits have since been cut back, the estimates of the annual tax revenue loss by 1986 as a result of the Accelerated Cost Recovery System adopted in 1981 ranged from $54 billion as calculated by the Office of Tax Analysis of the Treasury to $61 billion by the staff of the joint Congressional Committee on Taxation. The election by a new company to write up assets will depend on such factors as the relationship of the purchase price to the book value of the acquired company; the ability to ascribe large values to inventory, film libraries, mineral resources, or real estate for which there will be little or no recapture; and the amounts of equipment for which recapture would be onerous.

Another relevant ERTA provision increases the deductibility of principal payments of loans incurred by a leveraged ESOP from 15% to 25% of covered compensation. Together with the Tax Reform Act of 1984, ESOPs now give MBOs a major opportunity to shelter their operating income. Typically, the ESOP buys company shares at a fixed price, using funds borrowed from a commercial lender and secured by the promise of the employer to make sufficient contributions. The code permits deductions for contributions to repay the principal of the debt as well as the interest on it. The extraordinary effect is that the company can have an ordinary deduction (up to 25% of its payroll) equal to the sale price of stock in the company itself.

A number of large buyouts have relied on ESOPs as a source of financing. Their executives see ESOPs as a way to reduce the cost of capital, enlarge their own share of the new company's common stock, and allow them to pay top dollar if competitive bidding develops. ESOPs allow these advantages because they yield substantial tax savings and substitute for much or all of the "mezzanine" financing ordinarily provided by institutional investors. Finally, the ESOP can be "persuaded" to pay a higher price per share than the management.

In the Dan River buyout, for example, the new company was capitalized with two classes of common stock. The ESOP purchased 4.9 million class A shares at $22.50 each, and the management group purchased 1.7 million class B shares at $2.06 each. The company satisfied the ERISA requirements that the deal be both solely in the interest of the participants and "prudent" by giving the A shares superior voting and dividend rights, the benefits of which were, however, illusory. A bank loan agreement prohibited dividends, which in any event would have been imprudent. An ESOP committee – in which corporate executives comprised the majority – was to give instructions as to how the A shares were to be voted. After eight years, the "inferior" B shares – purchased at a more than 90% discount – were to be converted to an equal number of A shares.

ESOP savings can be spectacular. Because the Dan River ESOP owed the company $110 million, the savings on principal payments were about $50 million at an assumed federal income tax rate of 46%. The new company had also incurred $100 million of bank debt to fund the acquisition, less the capital expected to be repaid shortly after the closing out of the proceeds of tax refunds and the liquidation of pension funds and other nonoperating sources arising from the buyout. Since the company had an annual payroll of about $160 million, the ESOP enabled the company's management to win a bidding contest against a conventionally financed proposal, to project repayment of the $100 million bank loan in less than five years, and to repay half that loan's principal out of ESOP-created tax savings.

Leveraged buyouts existed before ERTA, but the generous bids made since its enactment seem to reflect the impact of additional tax savings on the cash flow projections that form the basis for the purchase price. Better auctions have helped pass the savings along to the shareholders of the public company, but they do not permit bidders to pay prices they cannot afford.

It is troublesome that – regardless of the source of the deductions – MBOs have been able to avoid all federal income taxes for a long time. In the Dan River buyout, various tax savings, the premature liquidation of pension plans, and other nonoperational sources accounted for two-thirds of the $150 million purchase price. These items account for more than the entire difference between the company's market price before the bidding began and the price ultimately paid.

Nontax costs are also significant. For Dan River, the out-of-pocket costs were $4.5 million on a transaction of $150 million; for Raymond International, $8.5 million on $219 million; and for Uniroyal, $48 million on $760 million. (It is not for nothing that stock jobbing is America's fastest growing industry.) The indirect costs, including management time and effort and the distracting effects of such a major change, are undoubtedly heavy as well.

The conflict of interest in an MBO also exacts a toll. Even though shareholders gain in a fair auction, auctions are expensive. Without auctions, costs would still exist because unfairness may have a multifaceted social cost. The cost of capital will rise if the legal or market system cannot protect shareholders from the risk that their hired hands will turn and force them out of the venture.

The truth about truffles

It would be foolish to suggest that MBOs do not produce real, as well as tax, gains – sometimes. In the late 1960s, it was fashionable to believe that the separation of general management from operating divisions in a conglomerate yielded important benefits. Now a newer, or perhaps older, view prevails – that people work best when wearing one hat instead of four, when decision making is unencumbered by layers of executives each in search of a function.

Management buyouts, whether of a whole company or a division, reflect this change in organizational strategy. The sale of a division to its managers is, of course, a step away from a diversified conglomerate. Even buyouts of whole companies are consistent with the notion of decentralization. The heavy debt load makes more acquisitions unlikely; often, as in the Uniroyal plan, the only realistic way to reduce debt is to sell off parts of the acquired company.

There are advantages to private ownership. Private companies are freer than public ones to focus on cash flow rather than short-term reported earnings as a measure of profitability. More important may be the substantial and positive incentives of the managers' once-in-a-lifetime opportunity to become quite rich. It is part of every MBO, because the investment bankers and their clients need to win the managers' favor if there is to be a deal at all, because the commercial banks and other lenders would be reluctant to agree to debt-equity ratios of 6-1 without an experienced management team, and because the heavy leverage makes it only prudent to create incentives to produce the large cash flows needed to meet those fixed obligations.

The new company's officers will operate under the aegis of directors with a personal stake in the venture and with well-developed monitoring and financial skills. Even the heavy debt burden is often thought a plus in the same sense that, according to Samuel Johnson, the certainty of hanging in a fortnight is said to focus the mind wonderfully. If the debt pushes an otherwise timid manager to make necessary but painful changes more promptly, the added burden will have been useful.

While these may be formidable advantages, some of the praise heaped on MBOs is undoubtedly self-serving or a product of the enthusiasm that often greets new developments in corporate finance. Heavy debt-service requirements can sorely limit a company's flexibility. The private company loses access to the public capital markets at the very time that it has weakened its financial condition. While it is sometimes said that buyouts are appropriate primarily for mature industries rather than rapidly growing ones, the need for reinvestment in mature industries can also be large. It is more a question of whether the industry is capital intensive, not how old it is.

View from a revolving door

Even if an MBO rejuvenates a seasoned management team, the benefit will be short-lived. The pattern of these buyouts is that the participants usually expect a six-year payout. The financial plan typically calls for elimination of excess debt in five to six years. At that point, the company will have reduced interest costs and can reschedule the remaining principal payments. The management group's employment agreements also expire at the same time, giving them the right to buy their shares in the new company, shares that will often have become remarkably valuable. And like most seasoned teams, they will expect to enjoy the good life and other fruits of their success, perhaps with a resale to the public.

The well-publicized $1 billion equity capital fund of Kohlberg, Kravis is also said to have a life of about six years, after which the fragments of ownership will be distributed to investors – who will presumably be more concerned with how they cash in their chips than with how they replace and reinvigorate their portfolio companies' managements. They have two choices: take the newly private company public again, leaving it to the allegedly perverse influence of the marketplace, or sell the business as a whole, which may have much the same result, particularly if the buyer is public. No matter how the company is sold, however, the much-discussed period of private entrepreneurial ownership will have been decidedly brief.

The problem is simply this: when the advantages of private ownership are largely based on, or at least coupled with, a heavily levered capital structure, extremely generous but short-term compensation arrangements, tax-sheltering devices of equally short duration, and an investor group that, in all likelihood, will not be content with paper profits for long, the arrangement is inherently unstable and will metamorphose into something quite different.

Why a mandated auction?

While the management buyout has changed a good deal in recent years, a basic conflict of interest remains. The owners of a business are confronted on a day – not of their choosing – by a salaried manager who announces that he is not working for them anymore. By itself that's not too distressing, but when the manager goes on to say that he is taking the keys with him and that, using the company's credit and proxy machinery, he will shortly buy the business at a price that seems fair to him and the company's advisers, the conflict begins to build.

What the shareholders currently receive is an auction – sometimes a vigorous auction, sometimes not. Because the market has been active recently, the managers have been unable to monopolize the bidding. The shareholders often have, in practice if not in law, a reasonable measure of protection.

But auctions are not assured. They began to appear only recently, and if the intense interest in corporate acquisitions ends, they may dry up. In addition, managers have begun to preempt the bidding. In the proposed buyout of Axia, Inc., the management group received a lock-up stock option for about 18% of the outstanding stock. In the Northwest Energy MBO, the board of directors granted Allen & Company, an investment banking firm, an option to purchase the company's most valuable asset, a pipeline, at book value. The ultimately successful third party bidder paid Allen more than $26 million to disconnect the pipeline option – money that presumably would have otherwise gone to the shareholders. More recently, Revlon and SCM employed similar crown-jewel lockups.

Depending on the nature of the business, outsiders may be unable to compete on reasonably equal terms with inside managers because the amount of inside information needed to bid intelligently is too large. Or, as in the Malone & Hyde buyout, the bidding may be skewed in the direction of benefits for management rather than the best price for the public.

A cash tender offer can also limit the bidding. Because of financial complexities, the usual MBO takes from four to six months to consummate. Until the closing, it remains vulnerable to a third party bid, particularly by a cash tender offer. For the first time, in the 1984 Malone & Hyde MBO, however, the investment bankers, Kohlberg, Kravis, made a management-backed tender offer for the public shares of Malone & Hyde – even while satisfying the margin requirements that often trip up other MBOs. The plan exposed the management proposal to competitive bidding for less than one month. Since then, American Sterilizer, Amerace, and others have used the same technique.

We should seriously consider making auctions mandatory, as then Commissioner Longstreth suggested in 1983. In theory, a rule of open bidding separates the decision to sell from the selection of the buyer. Any reasonable rule would require that the decision to sell be irrevocable – subject only to an upset price, terms of payment, or other conditions applicable to all buyers. Such conditions ought not be used to limit third party bidders' choice of things like management or plant location. The information required to bid, and the time to do so, would also have to be available.

What impact would a rule of open bidding have on the number of management buyouts? The stream of investment bankers courting management about buyouts would get a much less attentive hearing. If faced with the threat of a hostile third party bid, of course, corporate executives would still consider a buyout, not only because of the degree of personal security it offers, but also because it may represent top dollar for the shareholders. In a hostile takeover climate, buyouts would still seem to have a significant role, even with open bidding.

Mandatory open bidding would, in fact, codify what is already the best practice. Threatened by a third party takeover bid, for example, Cone Mills's management proposed a buyout at $68 per share. A special committee of outside directors decided to accept the bid on the understanding, according to the proxy statement, that the company would be free "to consider and, if appropriate, to accept, any other offers to acquire Cone that might subsequently be made by third parties." Management raised its bid to $70, and while an agreement in principle was signed that same day, the definitive agreement was not executed for two months, and the shareholders' meeting not held for four.

In the Malone & Hyde buyout, the management group proceeded not by a merger or sale of assets, but by a tender offer. If you combine Cone Mills's scheduling pattern and receptivity to third party offers with Malone & Hyde's tender offer procedure, you have most of the necessary features of an almost self-executing auction.

A rule of open bidding is difficult to challenge, either as a matter of law or economics. The rule is much fairer than one that allows insiders to freeze out shareholders subject only to their appraisal rights, and it restores some meaning to the duty of loyalty.

New York and other states have tried to make the appraisal remedy more adequate, but a remedy that requires individual shareholders to abandon their appropriately passive role and go to the courthouse has inherent flaws. Few of them would take such a step, it being, as one arbitrageur has said, a hard way to make a living. Aware of that, top officers have little incentive to offer a fair price because, other than appraisal, the courts have recently diminished the number of potential remedies.

The auction proposal would protect shareowners without requiring them to intervene in new and unaccustomed ways. It would help to deter overreaching and make bidding more competitive. A mandatory rule of open bidding would – over time and in competitive bidding – use productivity gains and tax savings to increase the price to the selling shareholders. Market forces would resolve the unsettled issue of whether publicly owned shares are less valuable than so-called control shares.

A rule of mandatory open bidding would have to be adopted at the federal rather than state level. Any state law that imposes delays on bids – even if limited to those made by management – may well violate the Commerce Clause as construed in 1982 by the Supreme Court in *Edgar* v. *MITE Corp.* and by subsequent decisions in lower courts. Regardless, if management were required to leave its buyout proposal open for a minimum period of time, all competing bids would have to be subject to comparable constraints, a matter already governed by the Williams Act. We need a single set of rules that could be consistently applied and with the flexibility that a federal agency, such as the SEC, could usefully provide.

Testimony of Bruce Smart

Former Chairman and Chief Executive of
The Continental Group

Former Undersecretary of Commerce for
International Trade

Before the Senate Finance Committee

January 26, 1989

Mr. Chairman, I want to thank you and your Committee for the chance to testify on hostile takeovers, a subject of great concern to the nation's economy, its businesses and workers, and I believe a significant deterrent to our international competitiveness and a threat to our economy.

My opinions flow both from my 32 years as an international business executive and from my service as a government trade official.

By the early 1980's, my former company, The Continental Group, had become a diversified international company, ranking among the "Fortune 100" in size, with operations in Packaging, Forest Products, Insurance, and Energy. It had revenues over $5 billion, employed over 40,000 people, managed assets with a book value of over $4 billion, and operated about 250 plants in 10 countries.

From its origins as Continental Can Company it had expanded internationally and into other packaging materials, and subseqently diversified into its other businesses, by internal growth, business purchases and friendly mergers. These diversifications enabled the company to provide earnings growth for its shareholders and career opportunities for its employees. The cash flow of mature businesses supported new ventures. In several product lines it was a world leader and innovator, but not all were equally successful or promising.

When I became Chief Executive Officer in September of 1980 (having been with the company since 1953 and its President since 1975) it seemed to me that a period of tightening was in order.

We therefore developed a strategy to sell those business units and assets that did not promise to earn at least their cost of capital, or contribute in an essential way to other units that did. Proceeds from these sales were to be used to strengthen our most successful operations, and broaden our international activities.

This strategy was driven in good part by the low price of our stock, and the company's low aggregate return on capital that the stock price reflected. Because Continental's ancestral can business was deemed to be "mature" by analysts, the stock traded as a "yield" stock, with the share price heavily influenced by dividend payout, prevailing interest rates, and current reported earnings.

As I remember it, in 1980 our stock was selling at under 70% of book value and around 8 times annual earnings, far below market averages.

In 3 1/2 years we sold off over $1 billion or about 1/4 of the company's assets, reinvested the proceeds, streamlined the company organization, improved earnings and added about 75% to the stock price in a flat market. We maintained the company's "A" credit rating, its strong cash flow, and its debt level at about 1/3 of total capitalization.

By June 1984 our activities had attracted the attention of Sir James Goldsmith.

His unsolicited proposal to pay $50/share, all cash, for all shares, a price far above our historic market high of $37, and our then current price of $35, was attractive to the institutions that owned around 60% of our shares.

We quickly evaluated all the "ploys" available to a defense-minded management. None seemed to us to be appropriate and fiduciarily responsible in our case, and so we set about developing alternatives to the Goldsmith proposal, simultaneously negotiating with him to raise his bid.

The biggest obstacle to orderly analysis was the threat of the 20 day time clock that starts once a hostile tender offer is formally announced. Twenty days is far too short a time to value a complicated company, seek out possible new bidders, investigate taking the company private, and to consider all the other options to accepting the initial offer that accompanied the so-called "bear hug".

In due course, our Board had before it three offers to consider - a new and higher one from Goldsmith, one from a major diversified company and one from an investment group led by the private construction firm Peter Kiewit Sons of Omaha, Nebraska. The management LBO could not match the other offers and was dropped.

We agreed to sell the company to the Kiewit group for $58.50 per share for all the shares, a premium of 67% over the pre-Goldsmith market price. Considering also the existing debt of Continental and the preference shares assumed by the purchasers, the total value of the transaction was well over $3 billion. To finance the purchase, the Kiewit group borrowed about $2 billion on a short term basis. The deal closed in November, 1984.

This high degree of leverage -- (as I remember it debt immediately after-acquisition totalled well over 80% of capital and interest charges exceeded earnings) -- meant that the purchasers had to begin immediately to dismember the company by selling most of its pieces.

Only the basic packaging business - our Continental Can unit -- was to be retained by Kiewit and it was eventually leveraged in L.B.O. fashion.

The effects of all this on Continental's various stakeholders were mixed.

The long-term common shareholders received a premium price, shared in part with arbitrageurs.

The debt holders saw the risk associated with their holdings rise, and their value decline.

Perhaps 400 employees suddenly lost their jobs. (In our restructuring, we would probably, over time, have reduced much of this "headcount" through attrition.) We had a pre-merger severance plan which was generous but could not, of course, compensate mid-career professionals for lost opportunity. Many companies do not have such safety nets in place and acquirers dislike them.

Employees of businesses sold lost company seniority and in some cases will end up with lower pensions than if they had spent an entire career with one parent company or the other.

The purchasers were able to sell off enough assets during a rising stock market to show a good return on their investment.

The new Continental Can lacked the financial strength to take on new long-term ventures and could be at risk should a significant recession occur.

Our employees, customers and suppliers had to learn to deal with a new management culture.

For at least a year, life in the company and its units was uncertain and for some traumatic. Personal concerns rather than the company's future occupied many employees' minds.

The City of Stamford lost a major corporate citizen and contributor.

Our largest licensee, a Japanese firm, could not understand what happened or why it was allowed.

A good management team was dispersed and a fine old company with a rich, decent and compassionate heritage disappeared, and we who are sentimentalists mourn its passing.

My conclusions are that the takeover situation is tilted heavily in favor of the aggressor, that takeovers reward only common shareholders at the expense of other stakeholders, and that the threat of takeovers focuses management on immediate reported results rather than on long term success.

I am concerned about the greater risk new leverage imposes on existing holders of fixed income securities, and its adverse effect on the ability of a company to weather adversity or engage in new ventures, and the possible harm to the larger economy.

Employees have fewer opportunities for promotion and professional growth, and reduced retirement security when a new, underfinanced owner takes over the company.

No employee has the ability to reinvest his past service with another employer, yet future promotional opportunities and retirement security are surely part of the implicit contract between employer and long-term employee.

For many young people starting careers, the financial returns of law or investment banking, made greater in part by this takeover binge, and the greater insecurity of corporate careers, discourage entry into engineering, marketing and manufacturing management. If fewer of our brightest young people join them, our companies bring to the international market place.

I am also concerned about the pressures the threat of takeover places on management to replace long-term planning with short-term financial manipulation. If a low stock price in relation to break-up value is what attracts sharks, then effective shark repellant will include all those elements that will inflate stock price.

Once a company is characterized as "mature", a "yield" stock, etc., it is hard for management actions to change investor perceptions. It is much easier for management to "improve" reported earnings by reducing the R & D budget, deferring maintenance, cutting pension funding to a minimum, capitalizing items that ought to be expensed, extending asset lives to reduce annual depreciation charges, and selling promising but unripened assets, counting on these moves to raise both stock price and price/earnings ratio.

To avoid a hostile takeover, it is also "wise", perhaps for management to substitute debt and its deductible interest costs for equity capital on which dividends are paid only after corporate taxes are extracted.

And it certainly is "unwise" for a "mature" company to diversify into a new business which consumes capital and management time without a prompt and commensurate return in increased reported earnings.

Despite these concerns, I think it would be wrong to remove market pressures from management`s incentives to perform, or to outlaw unfriendly takeovers.

The basis for a better approach may lie in the concept of "shared ownership", in which shareholders, lenders, employees, customers and suppliers are all considered to have a stake in the target company, and are compensated for any "damages" an unfriendly takeover may inflict on them. To the extent such damages occur and must be compensated, the acquirer will calculate these costs into the price he is willing to offer the common shareholders.

Such an approach might include some or all of the following elements:

-- a unilateral right of debt and preference share holders to "put" their instruments to the successor company at par or the pre-merger market price;

-- a substantial legally mandated severance plan for employees terminated or otherwise seriously affected as a result of the takeover, with the amount paid to reflect both length of service, loss of future pension benefits, salary, etc;

-- a requirement that pension funds remain intact, and company contribution levels maintained.

Alternatively, responsibility for pensions earned (retirees plus still-active vested employees) could be transferred to a large insurance company or other financially sound fiduciary. We should not let aggressors use generously funded pension plans to help "buy" the target company;

-- provisions that prevent the establishment of a "corporate veil" to shield the acquiring entity from the liabilities and obligations of the acquired target company.

-- a freezing of non-contractual employee and retiree benefits, especially health insurance.

-- a requirement that any historic pattern of improved retiree benefits (such as periodic inflation adjustments to pensions) be continued;

-- a unilateral right for suppliers and customers to abrogate or renegotiate existing contracts.

Beyond the concerns of "shared ownership", we must think of the effect of decapitalizing our economy on its stability and long-term competitiveness. Here our tax and securities laws may be useful vehicles to envourage financially sound actions. Possibilities of this type include:

-- Non-deductibility of interest or an excise tax on high degrees of leverage undertaken for acquisition purposes.

-- Removal of the double taxation of dividends.

-- Prohibitions on investment by federally-guaranteed institutions, such as banks and pension funds, in high-risk securities such as junk bonds, or taxation of the interest received on such assets.

-- More stringent standards for the capital-to-debt ratios of institutions engaged in financing takeovers.

-- Higher rates of taxation of gains from short-term investments than those held over a long period.

Any such new approaches should be structured to avoid discriminating against U.S. companies who may be bidding for assets in competition with foreign-based investors.

In evaluating this problem, Mr. Chairman, your Committee needs to be aware that many "experts" from the financial and legal communities have a vested interest in the continuation of the status quo and their advice is likely to have an element of self-interest in it, for takeovers have treated them well.

And if, as some experts believe, the decapitalization of industry by leveraged takeovers threatens the security of important American companies, and the banks and pension funds that now own them, you must consider that, at some future time, you may have to choose between using taxpayers' money for bailouts, or the alternative of massive business failures and unemployment.

Finally, I reject out of hand the notion that these takeovers occur only because management is incompetent and the aggressor better able to run the company. While there are surely exceptions, most targets are attractive not because they are badly run, but because they are complicated to understand (as ours was), or out of investor fashion, and thus undervalued. While many aggressors may be financial geniuses, few have spent time learning the art of day-to-day corporate leadership.

Mr. Chairman, if we are to win in an internationalized world economy, if we are to maintain the economic pre-eminence on which our national security and our standard of living both depend, we will have to do it through the medium of well-managed, well-financed, long-term-oriented private companies. We endanger our nation's future when we permit conditions that divert managements from their basic responsibility of producing quality products and services of high value to the world's consumers, and cause them instead to defend against financial manipulations lacking any value-added content.

Thank you for the chance to share my views on this subject so close to my heart over the last decade of my experience.

TESTIMONY OF DR. KATHLEEN P. UTGOFF, EXECUTIVE DIRECTOR
PENSION BENEFIT GUARANTY CORPORATION (PBGC)
SENATE FINANCE COMMITTEE
JANUARY 26, 1989

LEVERAGED BUY-OUTS, PENSION PLANS AND THE PBGC

Thank you, Mr. Chairman, for inviting me to appear before you today. Because of the changes in law under the Pension Protection Act of 1987--which this committee was instrumental in passing--the Pension Benefit Guaranty Corporation (PBGC) is in much better financial condition than it was a few years ago. The PBGC is able to meet its commitments to the 40 million workers and retirees who depend on PBGC's pension insurance safety net. Still, the pension reforms passed in 1987 will take several years to become fully effective and a changing and dynamic economy offers new challenges and risks--such as leveraged buy-outs (LBOs)--for the PBGC.

The PBGC insures defined benefit pension plans and it is these pension plans that have become involved in the controversy over mergers, acquisitions and the debt structure of corporations. The enormous amount of capital invested in pension funds and involvement of defined benefit pension plans in LBOs has led to several concerns.

--Are pension plans that invest in high-risk ("junk") bonds and LBO funds financially secure and will this investment behavior lead to losses for retirees and PBGC?

--Are well-funded plans being terminated so that surplus pension assets can be used to finance or fend off takeovers?

--Are highly leveraged companies more likely to fail and how would these failures affect pension rights and the PBGC, which insures pensions?

The first issue concerns pensions as owners of assets involved in takeover activity. The Department of Labor's Pension and Welfare Benefits Administration regulates the investment and fiduciary aspects of pension funds. Pension plans own stocks and bonds of takeover targets. They invest in LBO funds as well as high-risk bonds that may or may not be related to takeovers. These LBO investments and high-risk bonds, as part of a prudently managed, diversified portfolio do not represent risk to workers, retirees or the PBGC. Under current law pension funds may include other investments that carry higher levels of risk than takeover-related investments--such as venture capital and real estate investments. Further, a very small percentage of total pension assets are invested in the bonds and LBO funds that are being discussed here today. LBOs would go on without pension capital. On net, pension plans as investors probably benefit from the greater returns and increased stock value that results from LBOs.

The second issue is whether surplus pension assets play a role in takeovers. Do these so-called "excess assets" increase the possibility that a company will be targeted for a takeover or LBO? Are surplus assets used to finance or fend off takeovers? Are LBOs stimulating the termination of plans in order to remove surplus assets from pension plans?

When LBOs and surplus assets were a relatively new phenomenon, there were instances where surplus assets may have played a role in takeovers. I believe that the market now generally recognizes that surplus pension assets increase the attractiveness of a company and the value of those assets is reflected in the stock price of the company when it is a takeover target. In effect, the purchasers of companies with overfunded plans pay for the surplus assets. As long as stock prices fully reflect pension assets, surplus pension assets cannot cause LBOs.

Current data suggest that surplus pension assets are not a significant cause of, or source of capital for LBO activity. The PBGC reviewed all reversions greater than $100 million. In only two of the thirty cases was the company involved in an LBO. An additional four of the 30 were involved in a takeover. These results are generally consistent with other studies. One recent study, which is not conclusive, indicates that at most 7 percent of reversions over $1 million occurred within 1 year after an LBO. The same study finds that where there is a reversion following an LBO the amount of surplus assets is small relative to the acquisition price. Another study does find that terminations with reversions are correlated with takeovers in general. But the author does not conclude that takeovers cause terminations with reversions. Financial stress is probably the most important cause of plan termination. The correlation between takeovers and reversions may reflect the fact that takeover targets are also more likely to be firms experiencing financial stress.

In sum, there is little evidence to date that pension fund assets are either the culprit or the victim of LBO activity. This does not mean that there are no examples of pension involvement in corporate takeover battles or that new data will not identify problem areas. LBOs do not seem to be causing reversions and even when they are involved they are not a large source of capital. We are, however, continuing to research the role of reversions in LBOs.

Although the direct role of pensions in financing LBOs has received a great deal of attention, I am more concerned with the third issue, which is the effect of LBOs on companies that sponsor pension plans. Pension plans do not fail because of the investments they hold; they fail because the companies that sponsor them run into trouble. Financial distress can mean reduced funding of the pension plans and bankruptcy. These are the conditions that jeopardize pension security and the PBGC.

If highly-leveraged companies are more likely to fail, then the PBGC will be asked to step in more frequently as LBOs increase. The cost to the insurance program of those failures will depend on the funding of the pension plans and how much of the underfunding the PBGC can recover as a creditor in bankruptcy. Companies with high debt costs are more likely to fund pension plans at minimum levels required by law and they are more likely to apply for waivers of pension contributions. In addition, the distribution of assets to the shareholders in an LBO reduces the assets available to the PBGC as an unsecured creditor in the event of a bankruptcy. The net result of these two effects is that even if LBOs do not increase the probability that a company may fail, each failure when there has been an LBO, may be more expensive for the PBGC.

Let me discuss a case at the PBGC which illustrates our concerns over this issue:

Kaiser Steel was involved in an LBO in 1984. Nearly $200 million was distributed to shareholders and other parties involved in the restructuring. In 1987 Kaiser filed for bankruptcy and the PBGC was forced to take over the pension plans that were underfunded by about $200 million. The recoveries we can count on in this case are minimal--a portion of the reorganized company's stock and $1 million in cash. Kaiser simply had no assets to satisfy the claims of unsecured creditors. The PBGC was not the only loser in this case. Retirees had claims for health care promised by the Company that were worth several hundred million dollars. Retirees' recoveries on these claims were less than $10 million.

This case is not over. Lawsuits have been filed against virtually all the participants in the 1984 LBO. The retirees and the PBGC may recover something from the lawsuits but recovery amounts are speculative.

Kaiser is a good example of the complexities of this problem. The LBO was certainly not Kaiser's only problem. Kaiser's steel business had already been shutdown before the LBO. The problems of the steel industry are well known and the PBGC may have been forced to pay for Kaiser's pension plans in any event. Whether or not that is the case, the assets available to cover the pension underfunding would have been greater without the LBO.

The effect of the Kaiser LBO was to reorder the priority of different claims against Kaiser's assets. Shareholders, usually the lowest priority creditor in bankruptcy, profited--as they often do in an LBO. The distribution of cash to shareholders reduced the assets available to satisfy the claims of creditors. The effect of an LBO on the rights of different claimants has been the source of complaints from holders of bonds that were issued before an LBO. Bondholders are now beginning to put covenants in their agreements to protect their rights--a normal market response. The PBGC and retirees do not have the same opportunities.

Let me make it clear that my concerns about the possible effects of LBOs on the government pension insurance system are not a criticism of LBOs. There is evidence to support the belief that LBOs increase the efficiency and value of a company and that pension plans can benefit from that increase in value. But every party with a stake in a firm does not share equally in the risks and benefits of LBOs. The PBGC and other unsecured creditors, for example retirees with unfunded health benefits, may take risks without a proportionate share in the gains. This does not mean that LBOs have to be restricted to protect retiree benefits. We can explore other solutions to make sure that the legitimate rights of all parties that have a stake in a firm are not jeopardized by new and perhaps very useful corporate financing techniques.

COMMUNICATIONS

AMCO, INC.

In my Opinion

LET'S BUILD OREGON: THE REAL MEANING OF LBO

By

Roger S. Meier

Retired Chairman, Oregon Investment Council

Across the nation, from the Potomac River to the Columbia River, we're beginning to hear a rumble of questions about leveraged buyouts and what they mean for the economy. The LBO of RJR Nabisco has brought a once-obscure corporate financing technique -- and the debate over its benefits -- into our legislatures and living rooms.

In our state, the meaning of LBOs should be clear. Here, where companies like Fred Meyer, Safeway, Motel Six, and Red Lion have successfully restructured through LBOs and emerged as strong, fast-growing, good corporate citizens, LBO should really stand for "Let's Build Oregon."

Those who think money from LBO investments is gotten at the expense of American competitiveness or in return for useless paper shuffling condoned by greedy stockholders, lawyers, and bankers simply don't know the facts.

Thanks to our LBO investments, we've closed the gap on funding the small short fall in our Public Employees Retirement System. Thousands of workers have found good jobs as a direct result of corporate restructuring activity in the state. New businesses have flourished as a stronger tax base drew new investment and stimulated other opportunities for growth. And consumers have benefitted as newly competitive companies began to enhance and expand their products and services.

We've been using LBOs to our advantage since 1981, when Oregon became an investor in leveraged buyouts through the Public Employee Retirement System. As chairman of the body that oversees the state retirement system, a post I held for 16 years, I am proud to say that I watched LBOs become the best performing asset class in the state and make an important contribution to Oregon's economy.

State law requires that all of our investments be prudent, and I assure you that we take that mandate very seriously. The LBO fund we take part in gives us a stake in a stable, diversified, and high-quality portfolio of companies providing superior returns.

Its performance record has been sustained through recessions and expansions, through high and low interest rate environments. In fact, we've already received back more money from our LBO fund investments to date than the total amount we have invested over the years. Oregon PERS has invested $365 million in the common equity of 21 buyouts. All or some part of 13 of these investments have been realized, giving us a $445 million return on our original investment of $120 million. We still hold investments in 12 buyouts, with an estimated market value substantially in excess of their original cost of $245 million.

There's an added bonus to this. In Oregon the retirement money for members of PERS comes from two sources - employee payroll deductions and employer contributions. State employers, such as municipalities, school districts, etc., raise the funds for their contribution to the pool through local taxes. Exactly how much money each employer contributes depends on how well the State Pension fund is managing its money. The more money earned by PERS the less money taxpayers must pay into the pool.

But LBOs do more than add significant value to Oregon's retirement funds. They add significant value to the nation's economy.

You can see that value clearly in the case of a company right here in Oregon - Fred Meyer. Before the LBO, Fred Meyer had received many inquiries from potential buyers who most likely would have dismantled the company, changed its strategic direction, and moved the corporate headquarters away from its long-time home in Portland. An LBO allowed the company to continue its strategy and commitment to grow in the state and throughout the nation.

- Since the LBO in 1981 Fred Meyer has added 64 stores in four states, a 76 percent increase in store square footage that brings its total presence today to 112 stores in seven states. The company has added 12 new stores in Oregon alone and undertaken major remodeling efforts at 19 others. Growth has occurred both in the Portland area and in many rural areas of the state that were suffering from a recession in the forest products industry.

- The company has spent $300 million on capital expenditures, including upgrading truck fleets and investing in new computer systems.

- Fred Meyers' charitable contributions during those seven years totaled $13.5 million.

- Fred Meyers' Employment has increased from 11,000 just prior to the LBO to nearly 19,000 -- a jump of more than 70 percent. The company's employment in the state has increased more than 50 percent, from 6,800 to 10,300 people.

- The company's performance has been excellent since the LBO, with sales and income improving every year.

- And in 1986 Fred Meyer completed an initial public stock offering, giving the citizens of Oregon, along with other investors, the chance to realize ongoing value from equity ownership as well.

The Fred Meyer experience is not unique. We could tell similar stories and cite similar statistics for virtually all of the companies in which we've invested. Through an LBO a company can improve its competitiveness, position itself for long-term growth, and become an exemplary employer and corporate citizen. Don't let the words leveraged buyout scare you. This country is the better for this financing technique that makes its companies -- and states -- stronger.

1/11/89

BAKERY, CONFECTIONERY AND TOBACCO WORKERS INTERNATIONAL UNION

10401 CONNECTICUT AVENUE, KENSINGTON, MARYLAND 20895-3961 301-933-8600

Hold For Release
Tuesday, December 13, 1988

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BC&T Statement on RJR Nabisco Leveraged Buyout

The BC&T International Union has been carefully watching the evolution of the leveraged buyout of RJR Nabisco since CEO Ross Johnson announced his group's takeover bid on October 20. On November 30, the announcement of the conclusion of the action was made, with Kohlberg, Kravis and Roberts emerging as the successful bidder.

Because this union represents some 12,000 RJR Nabisco employees - who work in one of the 20 Nabisco plants in the U.S. and Canada, we are particularly concerned about the effect of this buyout on our members.

The history of leveraged buyouts shows sadly that the ultimate losers in this process are the workers, their families, their communities and the nation's economy.

Henry Kravis, senior partner of the firm that now owns RJR Nabisco, says that "We want to keep as much of the company together as possible. But clearly, we have to sell some of the food assets." Specifically, he noted that the group would need to sell about $5 billion to $6 billion worth of food operations in the next two years to finance the deal. We are, therefore, watching closely the new owners' plans and how those plans will impact on our members.

Our position regarding this and all leveraged buyouts reflects that of the AFL-CIO Executive Council. Our president, John DeConcini serves on that body as an AFL-CIO vice president.

The Council statement of May 1987 on Corporate Takeovers notes that "no economic or social benefit has been produced...To the contrary, millions of hours and billions of dollars have been wasted on the unproductive task of restructuring corporations while the 'product' has been saddled with unprecedented debt loads."

With the accelerated pace of such LBO's in recent years, it is obvious that tens of thousands of other union workers have suffered both directly and indirectly as a result.

At this time, we call special attention to the section of the AFL-CIO statement that urges Congress to consider legislation to remedy the abuses of the present system and we commend Senator Bentsen for pledging hearings on this matter by the Finance Committee, which he chairs.

We wholeheartedly agree that "those who mount a takeover attempt should be required to make full disclosure of their plans for the target company, as well as disclosure concerning their source of financing, their economic assumptions and other information relevant to investors, workers and communities..."

Further, we underscore the importance of the section noting that "contracts entered into by a corporation - including collective bargaining agreements - should be made binding on the corporate successors or new owners for the term of such contracts. To allow such preexisting contracts to be ignored if a reorganization occurs, incites restructuring for the sole purpose of reaping whatever gains can be achieved from breaching contractual commitments."

We call on the new owners of RJR Nabisco to meet the standards set forth in this resolution and urge them to consult with the unions that represent the workers at their plants before taking any steps that might adversely affect those workers.

We call on our members to stand in solidarity and in support of their local unions and their International Union so that the officers may do everything in their power to make certain that RJR Nabisco's new owners live up to both their contractual and moral obligations to the people who produce their products and their profits.

Nabisco plants are located in the following cities: Pittsburgh, Pa.; Buffalo, N.Y.; Denver, Colo.; Atlanta, Ga.; Buena Park, Calif.; Oakland, Calif.; Houston, Tex.; Chicago, Ill.; Niagara Falls, N.Y.; Richmond, Va.; Portland, Ore.; Philadelphia, Pa.; Fair Lawn, N.J.; Canajoharie, N.Y.; Longeuil, P.Q.; Montreal, P.Q.; Toronto, Ont.; Ste-Marie, P.Q.

# # #

STATEMENT OF
GILBERT BUTLER, PRESIDENT
BUTLER CAPITAL CORPORATION
BEFORE THE
SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Committee:

I am the President of Butler Capital Corporation (BCC), a firm that has been engaged since 1981 in structuring and financing management leveraged buyouts, primarily of small to medium sized companies. Prior to organizing BCC, I served as President of Term Capital Management Company and as a Vice President of Morgan Guaranty Trust Company. For over twenty years I have been involved in leveraged buyouts, credit evaluation, and analysis of public and private securities.

I am pleased to have this opportunity to express my views with respect to the recent increase in leveraged buyouts (LBOs). I will describe the activities of Butler Capital Corporation, discuss several concerns that have been raised with respect to LBOs, and comment briefly on some of the recent proposals for changes in the tax law.

I believe my testimony will demonstrate that responsibly structured LBOs -- and particularly those of small to medium sized companies -- serve a valuable function in our economy and should not be discouraged.

I. Description of BCC

BCC specializes in structuring and financing "management leveraged buyouts," transactions in which existing management of a company acquires a significant ownership interest. Four investment funds managed by BCC provide the financing for these transactions. During the past ten years these funds have invested over $750 million in 30 management buyout transactions, every one of which was developed with the full support of existing management and shareholders. These investments were not made because the company was put "in play" by someone seeking arbitrage profits, but often for the simple reason that the retiring company founder sought to sell his stock in a manner that would provide him the best price and would also help ensure the long-term success of the company. As is discussed in greater detail below, these companies have flourished during the period following the management buyout, demonstrated by significant increases in operating profits, employment, and long-term spending for capital improvements.

A typical management buyout sponsored by BCC involves the purchase of a privately held company, a relatively small publicly traded company, or a division or subsidiary of a larger company. One or more BCC funds provide capital through the purchase of senior and subordinated debt and, together with the active managers of the business, common stock in the company. Because BCC has the ability to provide complete financing for a transaction, it can structure a financial package tailored to the needs and resources of a particular company. The company's debt, for example, is carefully structured as to both interest rate and payment schedule in order for the company to have sufficient retained capital both for business expansion and to protect against an unanticipated drop in revenue. The capital provided by the BCC funds is used both for the acquisition of the stock of the selling shareholders and for the expansion of business operations.

A management buyout creates a powerful incentive for managers to operate a company in the most economically efficient and productive manner. When managers have a substantial amount of their own net worth invested in a company, they are far more likely to run the company in the most profitable manner possible than if they had little or no ownership interest. This incentive effect has been demonstrated time and again by the companies in which BCC has invested. Wasteful, inefficient spending is cut and spending for the long-term success of the companies, such as for capital improvements, is increased. The average increase in annual capital expenditures by the BCC portfolio companies following the management buyouts was 65 percent (computed on an aggregate basis) compared to the three years preceding the buyouts. An example illustrates this trend. Central Tractor Farm and Family Center, Inc., a Des Moines-based retailer of farm supplies and used tractor parts, received a cash infusion upon its BCC-sponsored management buyout in March, 1988. By expanding its operations into seven new communities, Central Tractor recorded a healthy 19 percent increase in sales and a 27 percent increase in profitability in the fiscal year following the transaction. Simply put, long-term investments in machinery, equipment, and buildings make good business sense when structured to increase operating efficiency. A management buyout of the type sponsored by BCC helps foster such investments.

There are, of course, alternatives to a management buyout for controlling shareholders to dispose of their stock. These alternatives rarely include equally effective incentives for existing management, however, and raise other concerns as well. Two such options include sale of the company to either a domestic corporate acquirer or to a foreign acquirer. The first option, acquisition by a larger corporation, will usually not permit the management of the acquired company to have a substantial ownership interest in the company. Thus, the important incentives created by having managers own an entrepreneurial stake in the company are lost. The second option, a sale to a foreign acquirer, often shares the same deficiencies as a sale to a corporate acquirer and also presents the broader problems inherent in foreign ownership of U.S. businesses. Neither of these options permit small- to medium-sized companies, which are a vital source of innovation and competition in our economy, to remain independent. The level of productivity of the BCC portfolio companies is significantly higher than the national average--a testimony to the incentive effect of stock ownership by management. The average operating return on net assets of the portfolio companies, for example, is 32.8 percent, which is at least 50 percent higher than the national average for industrial companies. If Congress were to discourage management buyouts, and hence encourage acquisitions by larger corporations or by foreign acquirers, productivity of similar companies could be expected to drift downward to the national average, thus harming U.S. competitiveness in the world economy.

Another alternative for shareholders seeking to sell a company is a public offering of stock. This is not an attractive alternative, however, for the shareholders of many privately held companies. The market for initial public offerings has continued to be depressed since the October, 1987 market break and often does not offer an opportunity for selling shareholders to realize full value on their stock. In addition, the kinds of companies in which BCC invests are in basic manufacturing industries that are often disfavored by investment bankers seeking to underwrite stock offerings in more "glamorous" areas such as high technology. Management buyouts, such as those structured by BCC, are thus an important source of capital for facilitating the transfer of ownership of a privately held company and in many cases will be the only source that will permit the selling shareholder to receive a fair price.

In sum, a responsibly structured management buyout, one that gives existing management a significant equity stake and that does not place an excessive cash drain on the company, has a number of benefits. It provides incentives for efficient management, allows a company to remain independent, keeps ownership in U.S. hands, and produces a fair price for selling shareholders.

II. Criticism of LBOs

A. Excessive transaction fees

A commonly voiced concern with respect to LBOs is that those who structure such transactions are primarily interested in short-term gain from transactions fees and arbitrage profits. This concern does not apply to the LBOs structured by BCC or by many other responsible LBO funds. Like most investment advisors, BCC receives a fee for managing its investment funds, based on the amount of capital under management. This fee is designed to cover salaries, office rent, and other overhead expenses, and is the only fee received by BCC. In addition, the BCC investment professionals share in the profitability of the BCC portfolio, thus giving them a direct incentive to work towards the long-term success of the portfolio companies.

Neither the management fee received by BCC nor the profit share received by BCC professionals is tied to the number of transactions completed. Notwithstanding the current perception of enormous fees involved in some LBOs, BCC does not charge investment banking, placement, commitment or other transactional fees, and hence has no incentive to enter into any acquisition that does not meet its stringent standards for potential growth combined with minimal risk. Reflecting its disciplined approach to investing, BCC has stayed out of the marketplace when conditions were such that these standards could not be met. Moreover, BCC spends a tremendous amount of time and effort in evaluating potential acquisitions. In 1988 BCC invested in only nine companies out of more than 650 potential transactions that were reviewed. BCC's profits are thus not created by engaging in any kind of financial gimmickry. Instead, they are generated by carefully analyzing prospective investments and by working closely with the owner-managers of a company after an acquisition in order to improve efficiency and to increase operating profits.

B. Excessive debt

Another concern with respect to LBOs is that the acquired companies take on an excessive debt load and will be unable to withstand a downturn in the economy or even a temporary drop in earnings. Although the companies in which the BCC funds have invested have a considerably higher amount of debt after the transaction than before, they have historical earnings and cash flow sufficient to support comfortably the additional debt. BCC and other responsible LBO sponsors avoid companies with an unproven financial record, but instead invest in companies with a long record of steady profits during periods of both expansion and recession in the U.S. economy. In addition, as described above, the buyout debt is carefully structured to allow adequate cash flow not only for payments on the debt but for expansion of the business as well. BCC's conservative approach to debt is demonstrated by the fact that its portfolio companies have never missed or deferred a single interest or principal payment during the ten year history of the portfolio.

C. Short-term perspective

A third concern voiced with respect to certain recent LBOs is that the pressure of debt repayment forces the managers of the acquired companies to take a short-term view of managing the company. Hence profitable divisions are sold off, plants are closed, employees are fired, and capital expenditures drop. Again, BCC's experience demonstrates that these concerns do not apply to responsibly structured management buyouts in which the debt level is not excessive and in which owner-managers are given an incentive for long-term success. There has been, for example, an average 30 percent increase in the number of communities in which the BCC portfolio companies maintain operations following the management buyout and virtually all senior management have continued with the companies after the buyout. Statistics regarding capital spending, employment, revenues and operating profits demonstrate clearly that the companies in which BCC has invested have been managed during the period following the buyout with an eye towards long-term growth and profitability:

Description	Average Increase During Period Following Buyout[1]
Capital Spending[2]	+ 65%
Employment	+ 47%
Revenues	+ 57%
Operating Profit	+ 59%

As the foregoing figures illustrate, BCC concentrates on the long-term growth and success of the companies in which it has invested, working closely with the owner managers. An example, the Frey Scientific Company, comes to mind. Located in Mansfield, Ohio, Frey is a nationwide catalog distributor of educational science supplies. Upon acquiring a significant ownership interest in the company, Frey's management acquired new product lines and greatly expanded its distribution facility to improve service and lower costs. Today, three years after the management buyout, Frey Scientific has approximately quadrupled its revenues and more than doubled its operating profits as a result of these actions.

BCC closely monitors the operations of its portfolio companies and is generally represented on the board of directors and participates in management at the policy level. It has frequent meetings with top and middle level managers with respect to issues such as budgeting, strategic decisions, long-term planning, hiring additional management personnel, and management compensation. Finally, and most importantly, BCC recognizes that the best formula for the long-term success of a company is to have a group of top managers that have a significant ownership interest in the company and hence have a powerful incentive for efficient management.

To summarize my response to the criticism of LBOs, I believe that BCC and many other investors in management leveraged buyouts of privately held companies serve an important function in our economy that should not be discouraged because of a few widely publicized excesses. By providing capital to facilitate a transition of ownership of a company, and by doing so in a responsible manner that encourages improved productivity, such investors create needed liquidity and positive incentives for growth.

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[1] These statistics are broken down in greater detail in Exhibits A and B. Length of period following buyout differs according to dates of acquisitions.

[2] Computed on an aggregate basis. Average increase equals 104%.

III. Proposed Revisions to the Tax Law

Because payment of a dividend is not deductible by a corporation while the payment of interest is, our tax system is biased in favor of debt financing. A number of proposals have been put forward recently that would address, either very broadly or in a targeted manner, this disparate treatment of debt and stock investments. These proposals include a fully or partially "integrated" corporate and individual tax system, disallowance of a deduction for some portion of interest payments on debt (such as payments in excess of a stated rate or payments in excess of a specified debt/equity ratio), and disallowance of debt used to finance a specified activity (such as a corporate acquisition). Although I will not attempt to comment in any detail on these proposals, I would like to make several general observations with respect to them.

Because of our tax system's bias in favor of debt financing by corporations, many government officials and academic commentators have suggested that some form of integration of the corporate and individual tax systems should be adopted, such as a corporate dividends paid deduction or a shareholder credit for taxes paid at the corporate level. An integrated tax system has much to recommend it. First, many of our foreign trading partners provide some relief from the double taxation of corporate earnings. Second, such a change could remove the perennially difficult problem of distinguishing "debt" from "equity" and would allow corporations to raise capital in the most economically efficient, rather than the most tax efficient, manner. Finally, an integrated system would remove the current tax disincentive to operating a business in corporate form.

While the benefits of an integrated tax system are substantial, there are also serious obstacles to the adoption of such a system, the greatest being the significant revenue loss that could result from such a change. Although some form of partial integration would be helpful, such as a deduction for a percentage of dividends paid, this could also prove to be costly and would leave the infirmities of the present system largely intact. In addition, the proposal to "pay" for partial integration by means of limiting the deductibility of interest (in effect making equity a little more attractive and debt a little less so) is not in my opinion a wise course of action. A general restriction on interest deductibility could have far-reaching adverse consequences to the capital markets by effectively increasing the cost of borrowed capital. Restrictions on interest deductibility would also create an advantage for potential foreign acquirers of U.S. companies who can borrow abroad and enjoy full deductibility of interest.

Finally, some integration proposals are flawed in that they would place the burden of paying for integration largely on pension funds and charitable organizations. Under one model, for example, the interest deduction for corporations would be disallowed and a non-refundable tax credit would be allowed for recipients of interest as well as dividends. Such a system would constitute an indirect tax on tax-exempt entities that would ultimately be paid by the beneficiaries of pension funds and of charitable organizations. Although integration of the corporate and individual tax systems is a desirable goal, I do not believe it should be achieved at the expense of charities and pension funds, nor, as indicated above, by increasing the cost of borrowed capital.

Instead of moving towards an integrated tax system, a number of proposals would attempt to shore up the present system of a double tax on corporate earnings. Some proposals would disallow all or a part of the interest deduction for corporate debt that is deemed to have certain equity characteristics. For example, it has been suggested that interest on debt that exceeds a specified debt/equity ratio or a specified interest rate should not be deductible. These proposals also present serious difficulties. A proposal keyed to debt/equity ratios presents practical problems such as the need to take into account the historical differences among industries, the fact that debt/equity ratios fluctuate significantly according to business cycles, and the need to develop a means for classifying the numerous businesses that do not fit neatly into a particular industry. More fundamentally, any effort on the part of the federal government to establish mechanical debt-equity ratios would deprive both the industrial and financial markets of needed flexibility. A rule based on a specified interest rate, whether floating or fixed, also presents similar problems in that such a rule could not accurately reflect the numerous variables that determine the cost of capital for a particular company. Such an approach could seriously disadvantage small start-up companies and those in high risk industries.

Finally, some tax proposals would limit the deductibility of interest only for certain transactions such as acquisitions of another corporation's stock or assets. Such proposals fail to recognize that management leveraged buyouts often perform a desirable function in our economy, and, in addition, are only a relatively small part of the overall trend by corporations towards debt financing. It would be unwise to respond to the criticism of a handful of large LBOs by enacting legislation that would discourage all LBOs and encourage foreign and corporate acquisitions at the expense of acquisitions by managers.

Any legislation specifically targeted at LBOs should take into account the beneficial effect of the relatively small, non-hostile, management LBOs sponsored by firms such as BCC. Section 279 of the Internal Revenue

Code, for example, which limits the deductibility of interest on certain acquisition debt incurred by corporations, generally applies only to interest in excess of $5,000,000. In 1987, the House passed a bill that contained a new section 279A, that would have further restricted the deductibility of interest on acquisition debt, and again the first $5 million of interest paid was unaffected. Any new legislation considered at this time should have an exception for small or medium sized transactions (a number of which could involve interest expense in excess of $5,000,000) that do not raise the same issues as much larger transactions. I would emphasize, however, that many of the positive effects of small LBOs are also present in larger transactions and Congress should not seek to restrict transactions that facilitate increased productivity and competitiveness of American industry.

IV. Conclusion

I believe that BCC, and similar firms, serve as an important source of capital that enables relatively small companies to facilitate a transfer of ownership and to expand business operations. By working closely with the owner-managers of the companies in which it invests, BCC helps these companies to increase productivity, increase employment, and to plan for the future. Any legislative action taken by Congress should recognize these important functions and should not attempt to discourage them.

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EXHIBIT A

Average Increases in Revenues, Operating Income, and Capital Expenditures Following Management Buyout

Company and Date Acquired	Revenues	Operating Income	Capital Expenditures
Golden State Foods September 1980	92%	140%	224%
Williamhouse-Regency(a) December 1982	57%	50%	24%
Ithaca Industries October 1983	57%	85%	134%
Pannill Knitting(a) April 1984	56%	57%	49%
Frey Scientific(a) August 1985	279%	208%	832%
SunMedia June 1986	10%	4%	N/A
Julius Koch November 1986	(2)%	(3)%	(63)%
First State Envelope December 1986	59%	16%	57%
Present Company October 1987	26%	35%	18%
Silvestri Corp. October 1987	49%	87%	50%
Lancaster Press December 1987	24%	20%	(45)%
Strine Printing(a) January 1988	34%	39%	34%
Central Tractor March 1988	40%	72%	83%
Arcon Coating Mills(a) June 1988	22%	19%	(50)%
Extrusion Dies October 1988	N/A	N/A	N/A
Steel Heddle December 1988	N/A	N/A	N/A
Totals(b)	57% Average Company Increase	59% Average Company Increase	104% Average Company Increase
	62% Aggregate Increase	60% Aggregate Increase	65% Aggregate Increase

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N.B. Data prior to transaction are the average of the preceding three years. Data subsequent to transaction are the average of all succeeding years. Operating income excludes merger-related items. When a transaction occurred during a fiscal year, the year's data were counted according to whether most of the year elapsed before or after the transaction closing date.

(a) Change of fiscal year occurred.

(b) Excludes new transactions, Steel Heddle and Extrusion Dies.

BUTLER CAPITAL CORPORATION

EXHIBIT B

EMPLOYMENT GROWTH IN PORTFOLIO COMPANIES

Company and Date Acquired	Time Period	Number of Employees, Time of Acquisition	Number of Employees at Recent Date	Percent Increase	Percent Increase, Annualized
Golden State Foods September 1980	7/80-12/88	924	1,703	84%	10%
Williamhouse-Regency December 1982	12/82-12/88	3,245	4,001	23%	4%
Ithaca Industries October 1983	10/83-11/88	5,186	6,960	34%	7%
Pannill Knitting April 1984	04/84-12/88	3,400	5,106	50%	11%
Frey Scientific August 1985	08/85-12/88	83	350	322%	99%
SunMedia June 1986	05/86-12/88	N/A	N/A	N/A	N/A
Julius Koch November 1986	11/86-12/88	134	127	(5)%	(3)%
First State Envelope December 1986	10/86-10/88	265	335	26%	13%
Present Company October 1987	12/87-12/88	1,453	1,642	13%	13%
Silvestri October 1987	10/87-12/88	316	380	20%	16%
Lancaster Press December 1987	09/87-09/88	494	547	11%	11%
Strine Printing January 1988	12/87-12/88	166	180	8%	8%
Central Tractor March 1988	01/88-12/88	900	1,050	17%	17%
Arcon Coating Mills June 1988	06/88-12/88	25	28	12%	24%
Total		16,600	22,409	47% Average Company Increase (Total)	18% Average Company Increase (Annual)
			Aggregate Increase:	35%	

Note: Extrusion Dies, Inc., acquired in October, 1988, has added one person to its staff of 114 subsequent to the transaction; Steel Heddle Manufacturing Company was acquired in December, 1988.

HELLO, WINNER

RJR NABISCO'S $5 BILLION GIFT TO THE U.S.

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With the pending acquisition of RJR Nabisco by a KKR lead group, much has been written about leverage buyouts, their size and risk, greed with the huge amount of money being earned by some, tax benefits of the interest deductions that the company would receive, and the effect on RJR people. If we can put aside jealousies from seeing other people making a lot of money, I believe we can then see what this transaction and others like it really are — a huge gift to us. If we and Congress don't, and the rules are changed again, then business owners will lose several trillion in value, the deficit of the U.S. will widen as tax revenues decline, productivity will suffer, and the people will have to make up the shortfall.

If all income recipients of the RJR acquisition paid full taxes currently, the transaction would net to a gain of $5 billion in Federal tax dollars as follows:

The increase in share price from $56 to $109 would generate a $12 billion gain which at a 28% rate yields taxes of	$3.4 billion
The potential gain from selling $6 billion of assets assuming book value of only $1.5 billion, generates a taxable gain of $4.5 billion which at 34% results in taxes of	$1.3 billion
Increased taxes on interest income generated or after tax proceeds (assuming a tax basis of $56/share and rate of 28%) were invested in 8.5% CDs vs. the much lower RJR dividend rate per share (present value 10 years)	$1.0 billion
The loss of interest income on the $5 billion of new equity is assumed covered by future gains	-0-
Less the loss in taxes from the interest deduction	-0.7 billion
Net Benefit	$5.0 billion

A major assumption in this calculation is that all income recipients pay full taxes currently. This has nothing to do with interest deductions or leverage buyouts. Congress has exempted pension and profit sharing plans, charities, universities, and other organizations from taxes so the full taxes will not be paid. Foreign investors will also pay less than full taxes.

The $5 billion is conservative since it does not include any tax revenues on the interest income earned by the debt holders. Since for every dollar of interest expense there is interest income, added tax revenues should be significant.

Interestingly, if RJR follows the pattern of other leveraged buyouts, the transaction will result in increased taxes paid by RJR, not less. A study by Steven N. Kaplan, an associate professor at the University of Chicago business school, found that in 76% of recent leveraged buyouts surveyed, operating income improved an average of 40% within two years. If RJR's pre-tax income before new debt grew at 20% per year vs. the 4.4% average it did the last six years, RJR's pre-tax income before new debt in three years would grow by $1.5 billion more, roughly approximating the new interest deductions. Over three years, this would cost about $700 million in taxes. However, over a six year period, there is actually a net gain of $155 million in tax revenues, assuming no principle is paid on the debt.

This income growth improvement is a very important and real element that needs to be factored into the equation. In leveraged buyouts, several changes occur. Management (sometimes new) is highly incented and takes on more of the owner mentality. The mountain of debt represents a real challenge. Both often result in a more intensely managed, more efficient company. Productivity improved in the 1980's at a much higher rate than the 1970's. It is no accident that this has occurred in the era of the leveraged buyout. This productivity growth helps us compete in the international market and keeps inflation down at home.

Removing the potential of a buyout on larger deals would only further insulate management in larger companies. This would lower productivity, growth, and profits. These reduce corporate taxes. *"During the 1983 to 1987 boom, when the U.S. created 14 million jobs, the Fortune 500 dumped a net of 1.3 million workers" (1).* Perhaps one reason is that many managers were forced to increase productivity and profits so their stock prices would appreciate, making the company harder to acquire. At say $30,000 per worker, the savings is $39 billion on 1.3 million workers or $13.3 billion per year in more Federal tax receipts. Interestingly, corporate tax receipts have increased rapidly during this same period from $37 billion in 1983 to $104.8 billion in 1987.

Yes, the leverage buyouts often cost jobs, as companies cannot afford to be as benevolent. This hurts people mostly in the short run. The long run efforts can often be a benefit. Many of these people start or purchase their own business and wind up enjoying it more. After all, the 15.3 million job increase from non-Fortune 500 companies has to be fostered in part by something. It seems that the era of LBO's and unemployment of 5.3% are more than coincidence. A simple comparison can be made with farms which produce more than we can consume or sell. Congress has refused to bite the bullet and do any real "restructuring". It's not only the $25 billion in annual subsidies and the billions of extra cost to consumers, but the human loss may be the worst part. These people could be more productive and have the personal satisfaction that they are adding value if they didn't work under the government. Yes, change can be painful and help is needed in the transition, but the result can be a major improvement.

Debating whether LBO debt is equity or debt is purely an academic exercise. The real question is which way helps or hinders the economy, people, and tax collections.

If Congress enacted an across-the-board removal of interest deductions in buyouts, the value of companies would decline precipitously. To get the same return on an equity investment constituting 10% of the purchase price, the price would need to be reduced by about 36%. Most acquisitions are for less than $25 million — the folks who created most of those 15.3 million increased jobs. Many are acquired with some form of outside or seller debt and even in the others the buyer factors in interest costs to own. There are over 800,000 corporations in the U.S. with sales of $1 million or more. If the average value was $100,000 ($80 trillion in total), a 36% decline in value is $29 trillion — translating to a $8.1 billion loss in tax potential. If the decline was only 10%, an $8 trillion loss in value and a $2.2 trillion loss in tax potential is staggering. The 25% market decline in October 1987 came at a time when Congress was advocating disallowance of interest on buyouts.

Greed is a relative term and when it's not illegal, unethical, or immoral, we can all benefit. In RJR, fees including golden parachutes could aggregate $1 billion or 8.3% of the increase from $56 a share to $109. Many people may not realize that major institutions invest money in leverage and venture funds where they pay 20% of the gains to the manager. Paying those who earn the money, incentivizes them to use their talents. Paying a famous entertainer $60 odd million a year results in many jobs. Paying a great tennis player heavy bucks years ago helped create the pro-tennis circuit which has added many new jobs and tax collections. I suspect there is at least a little greed in all of us and maybe Ronald Reagan was right when he wanted to get the government off our backs and gives us the freedom to do more. It is not the making of money that is evil. On the other hand, I do believe that God will ask what one did with all the money (LUKE 16:19-31).

Our changing times and leverage restructuring has people concerned about the risk. Well in RJR's case, the stock was trading about 9.6 times 1988's expected earnings and 8 times 1989's forecast -- well below the market average. The excellent food brands were being hurt under the cloud of the cigarette business. At the buyout price of $109, the P/E is only 18.6, 17% below the average price earnings ratio of public companies in 1987 according to W.T. Grimm & Company.

In order to assess the risk of carrying heavy debt, one needs to review the stability of earnings. For RJR, pre-tax earnings increased in 9 of the last 11 years with the largest decline only 8.5%. This is a fairly strong sign. RJR's new financial structure will have a debt equity ratio of about 3 to 1 — far better than most LBOs.

Sure, financing with much debt heightens the risk and the reward. History has shown that the reward has far outweighed the risk. The market is not stupid. It adjusts as it did for the Federated Store Offering. Yes, in recession times, you need to work harder and smarter. I remember joining a private company in October 1980 that lost money with $18 million in debt at prime plus 2 1/2% plus with no equity. As Chief Financial Officer, I watched our borrowing rate go as high as 24%. That company made it. Perhaps the more interesting question is what price the comfort of too little debt — to little improvement in operating income?

Some complain that too much debt squeezes capital expenditures. Well, it seems the guys who grew the most, created the most net jobs and tax revenues were those that had the least — the little guy who had to rely on his wits and bank loans because he didn't have much money.

Risks to lending banks are there but so are the rewards. The losses have been far less than loans for real estate, to developing countries, farms, and the oil patch. Ask any major banker if he'd rather lend to Brazil, Argentina, or Mexico, or an LBO loan. Unfortunately, our ten major banks are stuck with $55 billion in LDC loans vs. only $19 billion in LBO loans to American companies. With the LBO loans, they are far more diversified and have proven management on many. In 1987, the Farmers Home Administration incurred $22 billion in loan losses, more than the entire LBO portfolio of major banks. Diversification in many industries and across the country provides broader insulation against loans to one industry or location.

So the choice is up to Congress. Legislate more negatives on leverage buyouts and hurt the economy, jobs, and tax revenues — or leave it alone and help continue the good times of low unemployment, inflation, and prosperity.

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(1) David L. Birch, "After the Crash", Inc. magazine, December 1988 issue.

STATEMENT OF

THE EDISON ELECTRIC INSTITUTE

The Edison Electric Institute (EEI) is the association of investor-owned electric companies. Its members serve 97 percent of all customers served by the investor-owned segment of the industry. EEI members generate approximately 77 percent of all electricity in the country and provide electric service to 73 percent of the nation's ultimate electricity customers. We appreciate the opportunity to submit this statement with respect to this Committee's hearings concerning leveraged buy-outs (LBOs) and corporate debt.

Numerous proposals, mainly in the area of corporate taxation, have been suggested as a means of remedying the perceived abuses of LBOs and the concerns about high levels of corporate debt. While others have commented on broad economic concerns, with one exception, our comments will be restricted to the impacts on our customers and investors. The one broad comment we would make is that as a guiding principle, generally, we believe that capital markets should be given the maximum opportunity to operate and legislative restrictions should be applied only where there is wide agreement that there are significant abuses which must be remedied.

M&A Activity in the Electric Utility Industry

The incidence of mergers and acquisitions in the electric utility industry has been at a low level historically, and this trend does not appear to be changing significantly. Moreover, those mergers and acquisitions which do occur are typically motivated by the objective of reducing the cost of producing electricity through achieving cost reducing operating efficiencies.

Unlike most of the highly-publicized LBOs and mergers, such transactions are always the subject of intense scrutiny by multiple electric utility regulatory bodies. In fact, recent merger and acquisition proposals have drawn increasingly larger numbers of intervenors into the proceedings, thereby intensifying regulatory scrutiny. Moreover, unlike some highly-leveraged acquisitions, recently completed M&A activity in the electric utility industry generally has been accomplished by exchange of stock, rather than issuing debt as in some of the much-publicized LBOs.

Unintended Consequences Should Be Avoided

In exploring the issues that are the subject of the hearings, the increasingly significant role of the electric utility industry in our nation's economy should be considered since any action to curb LBOs may have inadvertant effects. Use of electricity as a percentage of U.S. energy requirements has grown from 32.2 percent in 1980 to slightly over 37 percent in 1987. Since 1973 when energy became a critical national issue, electricity use in the U.S. has increased over 40 percent while total energy use has increased only 2 percent.

Moreover, there is an increasing concern about the adequacy and reliability of electricity supply in the mid-1990s and beyond. In order to provide electricity, our industry is heavily dependent on stable and efficient capital markets. We invest billions of dollars annually in generation, transmission and distribution plant and equipment, making our industry the most capital-intensive industry in the U.S. In fact, we invest about $2.89 in land, buildings and equipment for every dollar of operating revenue. By comparison, the average manufacturing firm invests only $0.77 for every dollar of sales. In 1987, the construction program of investor-owned electric utilities totalled $27 billion.

Tax legislative proposals which impact interest and dividends could significantly increase the cost of electricity and could lead to additional difficulties in providing an adequate and reliable supply of electricity. Thus, these proposals could well adversely impact businesses that are not involved in what some would term abusive mergers, acquisitions and LBOs, and we, therefore, strongly encourage the Committee to carefully consider and analyze any possible legislation for unintended harmful impacts on our consumers and investors.

The Wide Sweep of Proposals Suggest the Need for Particular Caution

EEI is particularly concerned with many of the possible tax changes which have been suggested by various parties in response to the high visibility of certain leveraged buy-outs. These changes include, but are not limited to, suggestions for reducing or completely eliminating the deductibility of business interest. In particular, EEI is concerned with the thought set forth by some that interest payments are an alternative form of distributing operating income. Interest payments represent an expense of doing business comparable to any other business expense and, under long-standing tax law, are appropriately deductible in computing taxable income. In order to meet the obligation to serve contained in franchises, electric utilities must borrow money to build plants. Electric utilities account for about 20 percent of investment grade fixed income securities outstanding, the largest sector in a Salomon Brothers' survey of outstanding debt securities.

Our regulators treat interest expense as an expense of doing business. Essentially, our capital structure is regulated and virtually all regulatory bodies closely review the capital structure of their jurisdictional utilities to insure that the leverage is appropriate and there is a balance between the cost of capital reflected in the cost of electricity and the financial safety needed to provide an adequate and reliable supply of electricity.

The Need for Tax Law Stability Is Compelling

In analyzing the need for legislative action in this area, we also urge the Committee to consider the vast and sweeping changes which have been made in our tax laws during the 1980s, particularly in the area of corporate taxation, e.g., the over $100 billion increase in corporate taxes enacted as part of the Tax Reform Act of 1986. This decade has witnessed a major tax bill -- either being considered, enacted, or both -- every year. These changes place a significant burden on business. One need look only at the large number of depreciation systems which must be tracked. More importantly, businesses find it extremely difficult to engage in any longer range planning when faced with these frequent tax law changes or even discussions about changes. As an example, the Tax Reform Act of 1986 significantly reduced the cash flow of electric utilities. Thus, we believe that a moratorium on tax legislative changes should be observed in the absence of a compelling reason to proceed with legislation which would make fundamental changes to the tax code.

SUMMARY

Notwithstanding these concerns, EEI is prepared to work with the Committee to assist in studying the need for review of any legislative proposals in response to the leveraged buy-outs and the increase in corporate debt if it is believed that legislation is necessary. However, any such legislation should be carefully studied to determine the need for legislation and all possible effects before any action is taken. We urge the Committee to assess carefully the impact which such proposals could have on our approximately 80 million customers and 5 to 10 million investors.

We appreciate the opportunity to present our views to the Committee on these important matters.

STATEMENT OF
BRIAN F. WRUBLE
CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER
EQUITABLE CAPITAL MANAGEMENT CORPORATION
SUBMITTED TO THE SENATE FINANCE COMMITTEE
FEBRUARY 17, 1989

My name is Brian F. Wruble. I am Chairman, President and Chief Executive Officer of Equitable Capital Management Corporation, based in New York City. Equitable Capital is a subsidiary of The Equitable Life Assurance Society of the U.S., a mutual insurance company and the third largest life insurer in the United States. I also serve as an executive vice president of The Equitable and a member of its Investment Policy Committee.

Equitable Capital is an investment management firm, with approximately $33 billion in assets under management. These span a number of asset classes, including common stocks, publicly traded bonds, corporate loans in the form of privately placed bonds, government and agency securities, futures and options, and venture capital. About two-thirds of the assets we manage belong to our parent company or its affiliates. The remainder is managed for "third party" clients, including corporate, state and municipal pension plans, other financial intermediaries and international clients in Europe and the Far East.

On behalf of both our parent and a number of outside clients, we manage a large portfolio of publicly traded high yield bonds, many of which are associated with corporate restructures of one kind or another. In addition, we are one of the largest private investors in leveraged buyouts. For approximately 100 leveraged buyout transactions, we have been heavily involved in the restructuring itself, providing most or all of the subordinated debt. Our first such investment was completed about 15 years ago, but most of our activity in this area has taken place since 1983. In many of these companies, we also acquired substantial common stock or warrants to buy common stock. It is these 100 investments, where we have had a real chance to observe how the newly restructured companies operate, that have really given us insight into the leveraged buyout process.

We recognize there are some flaws in the LBO process, but on-balance, remain convinced that it is extremely beneficial for the U.S. economy. We believe that utilizing tax policy as a way of curbing abuses is far too blunt an instrument.

At Equitable Capital, we do not finance hostile acquisitions — not because we think they are immoral, but because the risks involved are greater than we feel comfortable with. Generally, we do not invest in companies where large parts of the company will be broken off and sold to others. Again, this is not because we think these are evil, but because they involve a type of "warehousing" risk that we don't normally wish to bear. We are not, for example, a part of the RJR-Nabisco transaction.

The names of most of the companies whose leveraged buyouts we have financed are not familiar to most people. The companies in our portfolio tend to be smaller businesses. They are often companies sold by conglomerates to their managers or retired founders passing an orderly transfer of control to the next generation of managers. Some are smaller public companies being taken private to escape the short-term focus on reported earnings and the costly reporting requirements of public ownership. *This kind of LBO, the small, private, non-hostile, non-"bust-up" deal is the mainstream of the business.*

According to one study, nearly 90% of last year's leveraged buyouts involved purchases of companies for less than $500 million. About 35% were smaller than $50 million.[1] The "mega-deals" get all the press attention, but the real All American deal involves the essence of the American Dream. It involves managers buying the business they have been running their entire career from a large and bureaucratic corporate owner; from an individual owner/manager who is retiring; or from anonymous and uninvolved public shareholders.

From what I hear and read, there are several issues surrounding the leveraged buyout phenomenon that are troubling to some members of Congress. These issues seem to be:

- Do leveraged buyouts cause unemployment?
- Do leveraged buyouts reduce competition?
- Is American business becoming overburdened by debt, perhaps making our economy more fragile, more vulnerable to recession?
- Is debt making our companies less willing or able to spend on research and development (R&D) or capital expansion, and reducing their long-term ability to compete globally?
- Is the use of debt being unfairly "subsidized" by the U.S. taxpayer, thereby exacerbating the budget deficit?
- Do LBOs result in an unfair transfer of wealth from existing bondholders to new stockholders?

Before I briefly address our view on each of these, let me say the following:

> Equitable Life seeks to be a good corporate citizen. As a mutual life insurance company, we are operated on behalf of millions of life insurance policyholders. We must comply with strict standards of fiduciary responsibility. We constantly ask ourselves whether our investments are socially desirable and productive. We believe that the restructuring activity taking place in America is an urgently needed process of renewal, of "regreening", of "re-entrepreneuring" the economy. We believe that leveraged buyouts are, as an investment class, a good thing. Like all investments, including stocks and bonds, some will be mistakes. That is the nature of investment risk. But we believe LBOs are helping to put back into American industry a competitive edge that has been lost.

THE EMPLOYMENT ISSUE

I remember, in the 1950s, when the word "automation" was causing considerable economic debate. Both government and labor expressed the concern that machines would replace men and women, that the new computers would throw millions of workers out of their jobs. A shortsighted analysis can easily lead to that conclusion. If a machine is purchased by an auto manufacturer to do a job that a man had done previously, and if that man is then laid off, have we not increased unemployment? Yes, but only over the short run and only at a specific plant. In the long run, that company was able to remain more competitive than it would otherwise have been, retaining more jobs, and even increasing employment. At the same time, the makers of computers and other automated machinery were able to grow rapidly, themselves becoming major providers of jobs and the core of an industry where America has held the international lead for many years.

Today we face a similar situation. Leveraged buyouts promote efficiency by cutting unnecessary expenditures, and, of course, some of those costs may be employment costs. However, it is the long-term effects that must be examined. The critical question is whether companies that go through the leveraged buyout process become more efficient and more competitive. If the answer is "yes", then any long term, dynamic analysis will show that leveraged buyouts help to increase employment by improving the ability to compete internationally. How would a visitor from another planet observe things? He would have a hard time understanding this concern about unemployment. He would see a decade in which leveraged buyout transactions grew into an annual business activity, totalling $100 billion. At the same time, he would see a decade of rapid increases in employment, with the percentage of the population employed at an all time high and the unemployment rate at a ten year low.

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[1] "Middle-Market Deals Dominated Activity in Buyouts in 1988", *Buyouts* (January 11, 1989); p.2

On a more anecdotal level, let me tell you the stories of two companies in our portfolio of investments.

During the late 1970s, The Equitable held a $100 million loan to a large"A"-rated corporation, a manufacturer of electric generating machinery equipment and farm equipment. The trends we foresaw in those sectors were troubling to us, so we called management in and said to them: "The world is changing; your industry is changing; but you're not changing. You can't continue to run your business as you have been over the last twenty years. What are you going to do about it?" The managers were insulted. They were outraged at the criticism and rejected the idea that there was anything wrong with the business. Today that company is in bankruptcy. Many jobs were lost. A leveraged buyout could have saved it. Going through an LBO creates an artificial crisis, a sense of urgency, a fierce desire to examine every detail of the corporate strategy to assure that the company can grow and survive. The company in our example lacked that sense of crisis. By the time they saw the iceberg, it was too late to avoid the collision.

My other example is a lot less grim. In 1983, The Equitable was involved in the leveraged buyout of a textile manufacturer. The managers who bought the company had tremendous pressure on them to make it perform. They faced two possibilities. With success, they could become masters of their own destiny and quite wealthy. With failure, they would lose all of their considerable personal investment as well as their careers. They responded as pure economic animals. They streamlined their product line, sacrificed their executive "perks" (which they had come to think of as waste), and demanded excellence from their employees, a number of whom were also new stockholders. Like any company that has experienced an LBO, this manufacturer used the discipline of its new debt burden to batten down the hatches and get the company moving in the right direction.

It was lucky that they did. About six months after they went private, a severe downturn hit the textile industry, the result of a strengthening dollar and vicious import competition. The company survived the recession and in much better shape than their competitors. Today their business is functioning stronger than before. The lesson to be learned is this: Companies which undergo a leveraged buyout tend to perform well during recessions because they're already running a tight ship. There is no question that, today, employment at the textile company is much greater than it would have been without a restructuring.

LEVERAGED BUYOUTS AND THE SPIRIT OF COMPETITION

Although RJR-Nabisco may raise questions about concentrations of economic power, the mainstream of the leveraged buyout business is the management purchase of businesses formerly owned by larger companies, typically conglomerates. Making new, smaller companies out of larger, more financially powerful ones has an encouraging effect: These "scrappy" new companies become fierce competitors. They fight hard for market share, and ultimately, it is the consumer who benefits. Again, what would a visitor from another planet find? He would see a period of dramatic disinflation occurring at the same time that leveraged buyout activity exploded. LBO success has obviously not been driven by the kind of price increases that one associates with reduced competition.

ADDRESSING THE CONCERNS ABOUT DEBT

Is American Industry becoming dangerously burdened by debt? We don't believe so. Obviously, adding debt to any company's balance sheet increases the financial risk of the company. The firm becomes less able to withstand a downturn in its cashflow. However, the ***total*** risk in any company is a combination of its financial risk, (i.e. the debt leverage), and its business risk. If we can make the company more focused, more efficient, and more competitive, then we reduce its business risk considerably. A study recently cited by *Fortune*[2] stated that "operating profit margins of LBO companies were 40% higher than their industries' medians two years after a buyout."

To achieve this improvement in business strength, ownership is placed in the hands of management by lending them most of the purchase price of the company. That temporarily increases financial risk, at least until the debt is paid down to more normal levels. There is a trade-off of reduced business risk for temporarily increased financial risk.

The amount of leverage added to a company that experiences an LBO is, in most cases, not as extreme as some seem to think. Typically, leveraged buyouts have about 10% of their total assets supported by equity. The average industrial company in the Value Line Composite Index has only about 40% of its assets supported by equity. It should be noted that if a company does "fail", rarely will it actually cease to exist; rather, creditors would take over to control operations.

In order for a leveraged buyout to take place, a number of different parties to the transaction must have independently examined the proposed investment. They must conclude that future cashflows are: (1) able to be accurately forecast despite the possibility of recession; and (2) likely to be strong enough to meet contractual debt payments. Senior lenders, normally banks, must do this analysis and satisfy themselves. Subordinated lenders, like Equitable Capital, must independently reach the same conclusion. Equity investors, including the managers who are buying the company and risking their own money, must do the same. Each of these groups stands to lose part or all of its investment if they are wrong. Each investor carries out its analysis with great diligence. Each team has veto power on the entire transaction since all elements of the financing must be assembled if the deal is to take place.

The result of all this scrutiny is that LBOs tend to take place in those industries for which cash flow is most stable, even when recessions occur. A recent study by Morgan Stanley bears out what we have observed in our own investing activity. To wit, there has been "... a concentration of leveraged buyouts in the industries that are best equipped to support them."[3] These industries exhibit low cash flow volatility and a high level of coverage of their fixed charges on a historical basis. Our own portfolio, for example, shows a concentration in broadcasting companies, newspapers, grocery chains and retailers, as well as specialty manufacturers who make products to serve the needs of stable end-markets. As a matter of investment policy, we do not invest in companies for which commodity price movements are critical, those which involve style or fashion, or where technology or the success of R&D is critical. The cash flow of these are all very difficult to forecast, therefore we do not believe they are appropriate candidates for a leveraged buyout.

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[2] J.P. Newport, Jr., "LBOs: Greed, Good Business — Or Both?", *Fortune* (January 2, 1989); pp. 66-68 "

[3] Stephen R. Waite and Martin S. Fridson, "The Credit Quality of Leveraged Buyouts," Morgan Stanley: pp. 9-15

IMPACTING RESEARCH AND DEVELOPMENT

We frequently hear the concern that R&D spending will suffer because of leveraged buyout activity. To us, this is not a realistic risk, since those companies for which R&D success is critical make very poor LBO candidates, and investors tend to avoid them. A number of the companies that have been "liberated" from ownership by conglomerates through the leveraged buyout find that they have more cash available to fund needed R&D and capital spending than when their former parent company was milking the excess cash out of them. Wilson Sporting Goods is an excellent example. Having lost much of its market share to competitors — both foreign and domestic — the newly independent and management-owned Wilson has been able to regain share by making investments in product enhancement that were impossible when it was owned by a much larger company.

OFFSETTING DEBT LEVELS WITH IMPROVED QUALITY OF BORROWERS

Finally, is there "too much" debt? Only the future will tell us for sure. However, a recent study by Goldman Sachs, which we agree with, concluded that "... fears that corporate debt increases pose a major systemic threat to the sound functioning of the economy and financial markets and will deepen the next recession seem overblown."[4] The study makes the point that the surge in debt during the current expansion followed a ten-year period of well below average use of debt by non-financial corporations. The current level of corporate debt today, relative to total corporate income, is not significantly different from its level in 1970. Moreover, as we might expect, much of the overall increase in debt is specifically related to leveraged buyout and other restructuring activity. As I have already stated, companies selected for the leveraged buyout are almost always those with the least volatile businesses. Therefore, ***the quality of the borrowers of much of this new debt is much higher than average.*** Their businesses are fundamentally more stable, making them better able to withstand recession.

Let me make one more point here. One obvious result of the leveraged buyout activity in recent years is a much higher level of the stock market than otherwise would have been the case. Those who decry the so-called "de-equitization" of the economy miss the point that companies who choose to issue new equity today can do so at much higher prices than would otherwise have been possible. Moreover, the higher stock market has raised the value of corporate and public pension plans. This lowers the cost of funding future retirement, thereby increasing corporate profits and reducing the budget outlays of states and municipalities. The strong equity market has increased the wealth of millions of American stockholders, enabling them to continue to support the longest economic expansion in peacetime history.

Going beyond this, the ease with which entire companies can be bought has a very beneficial effect on the stock market. It serves to dampen volatility, and therefore reduces the volatility of the entire economy. I remember sitting with a colleague around the time of the stock market's bottom in 1974. That was a brutal and protracted bear market. I asked him how it was possible that companies like General Motors could be selling for about four times earnings. His answer was this:

> "Stocks are only pieces of paper. They are only worth what someone else will pay you for them."

Today, the leveraged buyout investor, operating on the most rigorous of analyses, will buy an entire company if the price gets too low. Stocks no longer can become "just pieces of paper", detached from their investor value. Conversely, the LBO investor will not buy if the price gets too high, because the banks and insurance companies will not lend him the money. This provides a new stability to the stock market and to our economy. We saw the importance of this factor on October 19, 1987. Many observers will tell you that it was the threat to the tax deductibility of interest on money borrowed to finance acquisition transactions that was a key factor in triggering the market crash.

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[4] Giordano, Robert, "Debt Without Disaster," *Financial Market Perspectives*, Goldman Sachs (Dec. '88/Jan. '89); p. 2

ELIMINATION OF INTEREST DEDUCTIONS

Is the taxpayer subsidizing leveraged buyout activity? Is the use of leverage in restructuring exacerbating the Federal budget deficit?

I am convinced of one thing: Elimination of tax deductibility of interest on acquisition debt will not raise revenues. Instead, it will severely dampen the activity. Fewer deals will take place. Those that do will happen at much lower prices. Those prices might be found with the Dow Jones Industrial Average at 1000. Leveraged buyout activity is, over the long run, "revenue positive" from the vantage point of the U.S. Treasury. First, selling shareholders pay capital gains taxes at the time of the transaction. Moreover, since the general level of stock prices has been raised by the activity, taxes on all stock market capital gains are higher than otherwise would be the case. Second, the major providers of the loans for acquisitions are ***themselves*** taxpaying entities. Wilson Sporting Goods' deduction is someone else's taxable income. Admittedly, some debt holders are untaxed entities, like pension funds. However, in that case, there is a different public policy issue, unrelated to the fact that the debt was raised to finance an acquisition. The taxes on the high yield bonds held by pension funds ***will***, in fact, be paid when the benefits are distributed to pension beneficiaries. Over time, virtually every tax deduction in the economy becomes taxable income to somebody else. If it happens later, rather than sooner, this is the result of public policy designed to stimulate the formation of retirement capital for an aging population.

DEBT VS. EQUITY

One can make many theoretical arguments about whether or not some or all of the debt which finances acquisitions is really equity dressed up as debt. As a sizeable holder of debt instruments created to support leveraged buyouts, I can only say that we believe we own debt, not equity. Our holdings contractually bind the issuer to pay us a coupon and return our principal on specific dates. We enforce our contracts. Some have made the case that LBO debt is really equity because it carries equity-like risks. Does this argument make payments on office building mortgages in Houston nondeductible? It is not risk that should determine whether something is equity or debt. Rather, it relates to ownership and reward.

As debtholders we have none of the privileges of ownership. We do not vote, and we do not share when a company does better than expected. If a company hires a worker to do a job, it pays the agreed upon wage no matter how successful the company becomes. The wage is a deductible cost of doing business. Similarly, high profits in the business do not obligate the manufacturer to pay more for his materials. So, too, with the rent on a corporation's headquarters building.

Simply put, money is just another factor to be rented. If we finance a successful leveraged buyout, the company is not obligated to pay us any more than our bonds allow for. They have rented our money. We expect them to pay for it. If they succeed, as owners, they get the excess. If the company fails, we will insist that the owners feel the first pain.

This brings me to one final point, and I believe it is important to this issue: ***The purpose of debt in a leveraged buyout is not capturing the tax advantage***, although it does make transactions more attractive.

The purpose is to bring ownership within the financial reach of those who can make the company operate more efficiently. The LBO business is not a business of financial gymnastics. It is a business of people. It is "Capitalism 101". Fantastic things happen when you give a management team a once-in-a-lifetime chance. But very few management teams can accumulate enough capital to own, as a typical example, 20% of a $100 million company. If banks and insurance companies will agree to lend $90 million, it will take only $2 million for the managers to purchase ownership of a 20% slice. A stake in the business that is truly meaningful becomes financially within the grasp of the management team. The purpose of leverage is not the tax deduction. ***The purpose of leverage is to create a wide disparity between the reward for success and the penalty for failure.*** At its roots, this concept is no different from what takes place when a young couple borrows most of the money — a first mortgage from their bank, a second mortgage from a credit company and half the downpayment from their parents — to buy their first home. For many people this becomes the route to the accumulation of most of the capital they will have when they retire. If much of the interest were not tax-deductible, many of the nation's homes would neither be bought nor built.

I am not here to say that the business of doing leveraged buyouts is without flaws. We support prudent legislation to correct certain potential abuses. We are, for example, in favor of regulation to promote the fullest possible disclosure so that shareholders have the information and the time to decide whether to sell their stock. In addition, corporate directors should be held accountable for acting in the best interests of shareholders. We believe the antitrust laws should be reasonably and fairly enforced. We are concerned about the practice of paying fees, which vary with transaction success, to firms that provide "fairness" opinions.

However, on balance, an enormously beneficial process is going on. We urge Congress to do nothing which might thwart this necessary process, resulting in a refined and reshaped American economy.

I thank you for this opportunity to submit my position to the Committee. I am always available to speak with you further on this subject.

TESTIMONY OF
THE COMMITTEE ON INVESTMENT OF EMPLOYEE BENEFIT ASSETS
OF THE
FINANCIAL EXECUTIVES INSTITUTE

February 23, 1989

INTRODUCTION

These observations are presented by the Committee on Investment of Employee Benefit Assets (CIEBA), which is a committee of the Financial Executives Institute (FEI).

The FEI is an association of approximately 13,000 financial executives representing some 7,000 American corporations. CIEBA itself has 40 regular members and approximately 150 advisory members, all of whom are corporate ERISA-governed benefit plan sponsors with collective assets that total more than $450 billion.

The corporations represented in CIEBA cover a broad range of industry groups and asset size. However, it is important to note that CIEBA members - who manage their plan assets on behalf of more than 6,000,000 union and non-union plan participants - speak from the vantage point of those charged with fiduciary responsibilities under ERISA.

These comments are presented to the Committee not to address the specifics of potential legislation, but to provide some background on the investment of pension fund assets and to comment on related issues under investigation by the Committee. Although there are tax policy issues currently being debated that cause us concern, owing to their potential impact on the capital markets, we defer in those discussions, to the extent that they are not related to pension funds, to others with more expertise in tax policy. (The FEI has two such groups, the Committee on Taxation and the Committee on Corporate Finance.)

PENSION FUNDS AND THE U.S. RETIREMENT SYSTEM

We believe that, as currently structured, operated, and regulated, the retirement system in the U.S. has been on balance quite successful in securing retirement income for U.S. workers. It has remained healthy through the best and the worst of times in the financial markets and in the world for fifty years and more, in some cases, and benefits are more secure today than ever before. The aggregate private plan asset to liability ratio stood at 1.38:1 in 1987, and only about 17% of private plans are estimated to have been funded at less than 1:1 in that year.[1]

This mark of success can be attributed to a number of factors: the tax law which allows assets to accumulate without a tax burden; healthy financial markets over the past several years; and prudent asset management and funding strategies on the part of plan fiduciaries, working under the governance of ERISA since 1974. Besides establishing standards for investment practices, ERISA wisely, in our opinion, gives plan sponsors the flexibility to have investment policies that can evolve with the markets, subject to prudent expert tests. As a result, sponsors have been able to enhance fund returns and improve diversification by investing in a broad range of financial instruments and investment opportunities, some of which did not exist in 1974 when ERISA was crafted.

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[1] Source: Employee Benefits Research Institute

In addition to its achievements in securing benefits, the pension system, including both private and public sector retirement plans, has become the single largest source of institutionalized savings in the U.S. today. Despite a savings rate in the U.S. that compares unfavorably with other industrialized nations, the pension system has continued to be a growing and dependable source of capital for investment in the economy.

Few countries in the world place the retirement income burden so heavily on the private sector as does the U.S., and thus far, the results speak eloquently for caution in considering any changes. We urge the Committee to proceed with that thought in mind, and to be alert in addressing broader revenue or tax policy questions to the unintended implications for pension funds, in terms of both benefit security and general economic efficiency. Particular care should be taken to guard against unintended consequences or hardships for defined benefit plans, which are generally held to be most beneficial to participants.

CURRENT SYSTEM OF GOVERNANCE, OVERSIGHT AND REGULATION

Corporate plan sponsors operate within a system of economic checks and balances that goes beyond the essential legal framework. It is created by the economic nature of the pension system itself. Corporate plan sponsors understand that economic prudence, not just legal prudence, on behalf of both the plan participants and the corporate shareholders, requires a careful and continuous assessment of the tradeoffs between the opportunity to reap investment gains and the risk of loss.

In defined benefit plans, the sponsor has a legal obligation to deliver a promised level of benefits to the participants. Those benefits are paid for by a combination of corporate contributions and the earnings on the investment of those contributions. Defined benefit plans comprised approximately 27% of private plans in 1987, but accounted for 66% of trusteed private plan assets and, in 1985 (the most current data available), covered 72% of private plan participants.[2]

The plan participants and the corporate shareholders both benefit from investment policies aimed at maximizing pension fund returns subject to prudent risk-taking. For participants, higher fund earnings increase the security of benefits, and create less reliance on the corporation's ability to make future contributions. For shareholders, higher earnings reduce the amount they will ultimately have to pay to support a given level of benefits, and increase the dollars available to reinvest in the company's growth or to pay dividends. This, in turn, can help American companies in the aggregate be more competitive globally.

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[2] Source: Employee Benefits Research Institute

Similarly, participants and shareholders alike have a stake in controlling pension investment risk. If the value of contributed assets is decreased by investment losses, the participants will have to depend more heavily on future corporate contributions to secure their benefits. The shareholders will be required to pay more to deliver promised benefits, possibly detracting from the company's competitive position. Ultimately, it is the corporation and thus the shareholder - not the participant - who bears the risk of inadequate returns or investment losses in a going concern's defined benefit plan.

Many companies provide both defined benefit and defined contribution plans; some offer only one or the other. In a typical defined contribution plan, both the plan sponsor and the plan participants contribute specified amounts to the pension fund, and the earnings on those contributions are the only additional funds available for paying benefits. The participant, therefore, again stands to benefit from investment strategies aimed at maximizing return and controlling risk. The shareholder, although he has a less direct stake in a defined contribution plan than in a defined benefit plan, has an interest in prudent asset management because significant losses or relative underperformance would undoubtedly cause problems with employee welfare, morale, and productivity.

Aside from these economic considerations, which provide the strongest incentive for prudent asset management, it has been our experience that the overwhelming majority of pension plan managers live responsibly within the rules of all applicable laws and standards. In addition, through organizations such as CIEBA, most pension fund managers are proactive in their efforts to foster and maintain ethical standards. Since the enactment of ERISA, abuses by corporate sponsors have been rare.

ERISA is the major form of legal oversight for private pension funds. ERISA is jointly enforced by the DOL and the IRS, and is explicit in its requirements for prudence in asset management. In Section 404, the prudent man standard has been interpreted and applied as a prudent expert standard, requiring that a fiduciary "shall discharge his duties . . . with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[3] This is a higher standard than other corporate/security laws, which only require that there be no negligence or gross negligence. ERISA also prohibits certain transactions (Section 406); for example, it has very strict and well-defined rules governing the financial transactions of the plan with the corporate plan sponsor. In addition to ERISA, pension funds, like any investor, are subject to various reporting and other requirements of most federal and/or state securities laws.

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[3] Employee Retirement Income Security Act of 1974 (ERISA), Section 404(a)(1)(B)

In addition to the economic and legal incentives for prudence, there are significant checks and balances in place in the current system.

> First, checks by independent institutional fiduciaries are an added assurance that prohibited transactions do not occur. Assets must be held in trust, most commonly by a trustee bank (except for insurance contracts held by insurance companies), and to make an investment or withdraw funds, the plan management must direct the trustee to carry it out. The trustee has a legal obligation to check for prohibited transactions because it is a co-fiduciary. In effect, in order to misuse the plan assets, a plan sponsor would have to have the consent and knowledge of the trustee and the money manager involved.
>
> Second, there is typically a committee of the board within the sponsor corporation charged with oversight of the pension plan management. Such committees exist in approximately 92% of companies affiliated with CIEBA, according to our recent member survey.
>
> Third, private plans are audited by independent public accounting firms, and typically also by internal audit staff.
>
> Finally, the Department of Labor audits a sample of private funds each year. The DOL has also been aggressive in policy-making and in using moral suasion to ensure the proper discharge of fiduciary duties on such issues as proxy voting and directed brokerage.

INVESTMENT OF PLAN ASSETS

ERISA requires that fiduciaries discharge their duties "solely in the interest of the participants and beneficiaries" and "for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan".[4] This requirement means that plan fiduciaries must make investment decisions to provide the best possible assurance that the pension promise will be honored; therefore, the overall fund return should be maximized subject to a prudent level of risk. The appropriate level of risk is determined by a variety of factors, including the plan's projected payout obligations, the extent to which assets already in the fund cover projected liabilities, and the ability of the corporation to make future contributions.

In the investment process, the first and most fundamental decision made is the asset allocation decision, or what proportions of the fund should be invested in various asset classes such as stocks, bonds, real estate, etc. The allocation decision is based on analysis of the risk/return characteristics of alternative investments, the correlations among their return patterns, the fund's liquidity needs based on anticipated contributions and payouts, and other factors. The risk of the total portfolio is reduced by diversifying investments among and within asset classes, because judicious diversification serves to partially offset relative under- and overperformance in some assets with that of others. ERISA, in fact, explicitly charges fiduciaries to "diversify . . . the investments of the plan so as to minimize the risk of large losses . . .".[5] Some of the investments included in a well-diversified portfolio could be judged in and of themselves to have a relatively high element of risk, but could prudently be included if the expected returns were commensurate with the risk and if the proportion of such assets were sufficiently small. Designing a portfolio to include such assets can increase the expected return of the total portfolio without proportionally increasing the total portfolio risk.

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[4] Employee Retirement Income Security Act of 1974 (ERISA), Section 404(a)(1)(A)

After the asset allocation decision is made (or revised), the funds are committed (or shifted), either by means of "in-house" investing or through independent investment managers. It should be emphasized that the asset allocation does not typically change significantly over the short term, and plan sponsors, governed by the long term nature of pension payout obligations, generally invest with a long term view. Although liability profiles differ among corporations, sponsors are generally less concerned with short term movements in valuations of asset classes than with longer term expected returns of the entire diversified portfolio.

Recently, attention has been brought to bear on increased short term asset turnover among "active" investment managers (i.e., those who attempt to exceed the return level of the overall market), some of whom manage pension fund dollars and, it has been postulated, trade more frequently because of pressure for short term performance from plan sponsors. It is our belief that most sponsors generally evaluate the performance of their investment managers on a three- to five-year time horizon or longer, which suggests that longer term evaluations are the more general rule. If trading volume among these managers has in fact increased, there are also other factors and recent trends in pension management that would balance out such an increase across the total fund. First, pension funds have substantially expanded their investments with "index" or "passive" investment managers, i.e., those who attempt to replicate the returns of the overall market. Trading activity in these accounts is of substantially lower volume than in active accounts. Second, pension funds have increased their investments in the private markets, such as real estate investments, venture capital, etc. Such investments are long term in nature and normally are not traded actively nor through the public markets at all.

It should also be noted that many of our members do not subscribe to the view that active trading per se is necessarily undesirable for the markets. Active trading contributes to overall market efficiency and investment liquidity, which adds to the attractiveness of an investment for most investors.

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[5] Employee Retirement Income Security Act of 1974 (ERISA), Section 404(a)(1)(C)

CORPORATE GOVERNANCE ISSUES (PROXY VOTING)

Although pension funds purchase equity securities for investment rather than control purposes, we are ipso facto owners of corporations as well. With ownership comes the responsibility to exercise ownership rights, including the voting of proxies. In accordance with ERISA, these voting decisions, like investment decisions, must be made solely for the purpose of furthering the interests of plan beneficiaries. In a change of corporate control situation, this requires approaching the decision with no bias toward either the existing management or the prospective acquirer, and maintaining continual study and analysis of the actions of all parties to assess where the greatest value lies.

As required by the recent DOL opinion letter regarding proxy decisions, such decisions are made either solely by the sponsor, or solely by the investment manager who is managing the investment. If the sponsor does not reserve the right to make the voting decisions, it cannot interfere with the decisions of the investment manager, who will have been charged to vote according to the best interests of the plan beneficiaries.

PENSION FUND INVESTMENT IN LEVERAGED BUYOUTS (LBOs)

The 1980s have been a time of heightened corporate restructuring activity of many kinds, including divestitures, asset sales, mergers, acquisitions, and LBOs. Much of this activity, we believe, can be attributed to changes in the optimal mix of corporate assets and business ventures demanded by a rapidly-changing and increasingly globalized business and economic environment, as well as to an unwinding of some of the conglomeratization activity seen in the 1970s.

At the same time, we have seen a significant expansion in the aggregate level of corporate debt - a phenomenon that we believe should only be evaluated after a thorough examination of a wide range of factors, including the relative indebtedness and competitive position of U.S. firms vis-a-vis their foreign counterparts. While the complete picture of what has driven this second trend has not yet become clear, it is certainly true that any kind of restructuring activity can be financed with a large proportion of debt, and indeed there are significant tax incentives attached to doing so. Other corporate actions, such as stock repurchases and borrowing for capital expenditures, can also heavily weight a capital structure in favor of debt and increase financial risk.

Accordingly, it is our belief that it is important for the Congress to analyze LBO activity in its broader economic context, not as the sole driver of these more fundamental trends. Even though an LBO is largely financed with debt, and so most likely makes a greater than proportional contribution to the aggregate level of corporate debt, we feel that an attempt to address these broader trends by targeting LBO activity would be ineffective and might possibly have unintended consequences for other sectors of the markets.

According to our recent CIEBA member survey, approximately 1% of our assets are invested in LBO equity and/or debt, and about 30% of our members commit funds to these investments. Investments are made either through limited partnerships or, for a few very large funds, by means of direct investments in individual companies. Partnerships are managed by a "general partner," who typically invests only a relatively small proportion of the total capital, but shares more than proportionally in the profits from the investments. General partners also charge fees for managing the fund. Partnerships offer the protection of added diversification, since the funds own or invest in more than one company (typically a dozen or less); the "limited partners" (pension funds and others) are thereby largely shielded against a failure in any one company.

Sponsor fiduciaries who do invest in LBOs do so because they provide a high level of expected return and they enhance the return of the overall fund. Among CIEBA members, mature partnership investment returns typically have ranged between 25% and 60%, with no investment losses to date. (Mature investments are the relevant measure; LBOs typically are structured with a four- or five-year time horizon with only minimal returns, or none at all, expected in the early years.) Returns on direct investments are in general higher, largely because of the absence of a general partner: there are no partnership management fees, and profits are not shared with a general partner. Since these investments are in individual companies, they do not provide the protection of diversification that partnerships do, and they therefore require more extensive analysis that would generally only be feasible for large, reasonably well-staffed plan sponsors.

While the returns associated with LBO investments are typically very high, they do carry higher levels of risk than most other forms of pension investments. Risk, however, cannot be isolated as the sole criterion for evaluating an investment. The investment must first be evaluated individually, balancing the risks against the expected returns, and then as a component of a larger portfolio of assets. Individually, the level of risk present in any investment is directly related to its expected returns: assets in demand in the marketplace, by pension funds as well as other investors, are in demand only while their expected returns exceed or are commensurate with their perceived riskiness. In a portfolio, each asset's effect on the risk/return profile of the entire portfolio is the relevant measure for tests of prudence, not just the riskiness of each individual asset. As outlined earlier, including a relatively small proportion of high risk/return investments in a portfolio can enhance the overall return of the portfolio without proportionally increasing the overall level of risk.

Pension fund investments in publicly traded high-yield bonds must be examined in a similar way. High-yield bonds are less than investment grade debt (generally, below a BBB rating), with relatively high risk and expected returns. While they are used to finance some LBOs, they also provide access to the debt markets for emerging credits, or companies which are not yet healthy or large enough to merit an investment grade rating, and for companies whose debt ratings have been downgraded.

As noted, we found in our survey of CIEBA members and advisory members that about 1.0% of our pension fund assets are invested in LBOs, including both direct investments and limited partnership investments. LBO investments and publicly traded high-yield bonds together constitute only about 2.3% of our assets. With such a small proportion of assets involved, even failure of all such investments would not jeopardize the security of the pension promise. In fact, as noted earlier, the overall financial status of private funds is quite healthy, even as such investments have become more commonplace.

In order to further reduce the potential risks to the assets invested, we are also diligent in our analysis of LBO investments, as we are for all investments, recognizing that risk is a key element in these transactions. For partnership investments, we examine the history and experience of fund managers, in terms of experience, background, record of price discipline, whether or not they invest in hostile takeovers, and other factors. For direct investments, we perform extensive financial analyses based on worst-case and recession scenarios. After investing, we exercise due diligence in monitoring, as again we do for all fund investments.

Even though the aggregate proportion of our funds invested in LBOs is quite small, and our perspective is that of the investor, not of the economist, we do not make investments that we believe may be detrimental to the economy over the long term, because we would be doing a disservice to our fiduciary responsibilities by damaging our future investment opportunities. While we would not assert that all LBOs and high-yield debt financing decisions are strategically sound, we believe that a conclusion that all such activity is inherently harmful to the economy would be equally inaccurate.

We do not propose to enter the debate about the economic implications of LBOs as a proponent or as a critic. There is, in fact, no consensus of opinion within CIEBA on either side; neither does there appear to be a consensus among government officials, in academia, or in many other sectors. The potential negatives have been amply covered in the press and in other Congressional testimony, and these views are shared by some of our members. They raise questions about the fate of these companies should the economy slide into a recession, the implications for employment and divestiture of assets, the negative effect on the value of the company's already outstanding debt securities, and the potential incentive for divergence of funds to debt service from investments in such activities as research and development.

CIEBA members who have a more favorable view of LBOs point out that LBOs can have many positive economic effects and can serve worthwhile economic purposes. Some (35% of LBOs in 1988) are undertaken simply because of a desire to sell on the part of the current owners, such as in corporate divestitures and sales of family-owned or otherwise closely held businesses.[6] Most result in extremely high returns to the existing shareowners, including pension funds. With regard to the longer term implications for productivity and employment, these members feel that a capitalistic economy in the aggregate becomes more efficient in transfer of control situations, because employees and assets will tend to be reallocated toward their "highest and best use," even if short term dislocations occur. In the aggregate, the national unemployment figures will not support the supposition that most dislocated employees remain out of work.

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[6] Source: Venture Economics, Inc., Wellesley Hills, MA

There is also debate about whether or not the Treasury suffers a net revenue loss in an LBO. Some commentators have postulated that the Treasury in fact reaps a net benefit from an LBO: while interest deductibility reduces revenue from corporate income tax, the loss may be more than offset by tax revenues from sometimes more than 100% capital gains by taxable shareowners, from tax on interest earned by taxable debtholders, and from tax on fees earned by agents. Few LBOs, incidentally, are disproportionately large in dollar value; in 1988, fully 94% were under $1 billion in transaction size, with 88% under $500 million.[7]

The notion that does come through clearly, in our opinion, is that this issue is extremely complex and requires much deeper analysis than has been possible to date, and more time for the underlying economic forces to surface. We urge extreme caution in crafting a legislative solution at this time. Overall, we feel that the market itself is the best regulatory mechanism for excesses, if they exist, and that it has, in fact, already begun to adjust. A legislative correction, besides being extremely difficult to design at this relatively early stage, carries with it the added risk of creating distortions in the markets and hampering their ability to self-adjust, especially if new laws should result in differential treatment among market participants. As the market forces evolve, close monitoring and study may reveal that legislation is in order, but until then, we feel that the risks outweigh the possible benefits.

For pension funds in particular, we would be seriously concerned about any prohibition or limitation on pension fund investment in LBOs or other investment options for several reasons.

> First, there are more than enough economic and legal safeguards in place to assure that benefits are not being jeopardized, and the current participation level for the investments currently receiving attention is far too low to cause concern for benefit security. We believe that ERISA is quite clear in its charges to fiduciaries, and that the flexibility it permits in allowing investment policies to evolve with the markets is an integral part of that mission.
>
> Second, if the independent policy decision is made to curb LBO activity in general, then we do not believe that that goal could or should be accomplished by amending ERISA, which would affect private pension fund participation. As long as investment returns remain attractive, any void left by the absence of private pension dollars would quickly be filled by other providers of capital not subject to government restrictions, such as foreign investors. We again believe that the market is best equipped to

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[7] Source: Venture Economics, Inc., Wellesley Hills, MA

place a check on excesses, if they exist; when opportunities for advantageous realignment of assets abate, the pace of restructuring activity seen in the 1980s, of which LBOs are only a part, will undoubtedly slacken unaided.

Third, from a larger perspective, we believe that restrictions on corporate restructuring should be carefully examined for their unintended implications for the viability of the capital formation process. Eliminating financial buyers such as pension funds or buyout partnerships would limit many companies' options for sources of capital to other corporations or non-U.S. investors, and could possibly work to the detriment of corporations in their asset redistribution activities.

Finally, as we pointed out at the beginning of this testimony, we would urge caution in tampering with a retirement system that works, and that has withstood far more severe tests than this for many years. We are confident that it will survive this one.

Norman C. Johnson
16178 Mount Craig
Fountain Valley, CA 92708

January 12, 1989

Ms. Laura Wilcox
Hearing Administrator
205 Dirksen Office Building
Washington, D.C. 20510

RE: Finance Committee Hearings on
Leverage Buyouts and Corporate Debt

Dear Ms. Wilcox,

Perhaps it truly is time for a closer look at corporate leveraged buyouts. Such a look may uncover more benefits that negatives ... for the parties involved and the economy in general.

While some of the Super Mega-Mergers, such as the recent RJR event are so complex and smack of maneuverings that make the ordinary man's head swim, these few deals are only the headline grabbers and are the exception.

The truth is that even most of the larger deals are put together because there is strong evidence that the company can be run more efficiently and profitably, continue to grow, and provide more employment under the new owners. These new owners are often the old managers who, no longer saddled with layers of bureaucracy above them, can get down to making the company work, while servicing the debt.

Most deals, however, are not mega-mergers. Most are sales of privately held businesses whose owners have decided to sell. Without the ability of a buyer to leverage the deal, the number of buyers available would drastically be reduced. Even if leverage is still possible, if the interest were to be non-deductible, the potential return on investment would be reduced. In both cases, the net effect would be to significantly reduce the transaction values of these businesses. This not only robs the owner of rightful value, it also robs the government of the taxation on the higher value. Moreover, if values drop, fewer owners will be able to sell, depriving the Government of the considerable tax revenue that it now enjoys on such events.

If the Government's concern is the Corporate tax deduction for the interest on the Leverage, it should be noted that the interest does not drop into a black hole! Interest payments provide jobs and profits for other entities (banks, financial groups, and private investors) that provide a major tax base for the government. In fact, because the lenders are service industries, the bulk of their pre-tax costs are in salaries which are taxable personally. In other words, this interest keeps capital working in a major sector of our economy. This in turn generates more jobs, revenues, profits, and taxes.

Finally, ownership change in a business is usually healthy. The new owners are usually more dedicated to expansion and growth than the sellers were. Those who are lenders are rarely throwing money blindly at these new owners. Rather, they provide close monitoring and regulation of business operations and solvency ratios to ensure the success of the venture.

Further laws and regulation in the area would seem unnecessary as prudent businessmen in a free Capitalistic Society should be free to make their contributions to the economy without further regulatory pressures. Additional regulations and laws would only serve to dampen the economy while increasing the cost of Government. Both events would serve to further increase the deficit! I strongly urge a conservative approach as you review this subject.

Sincerely,

Norman C. Johnson

NCJ:ja

NATIONAL
FARMERS
UNION

December 19, 1988

Hon. Lloyd Bentsen
Committee on Commerce, Science and Transportation
United States Senate
Washington, DC 20510

Dear Senator Bentsen:

1988 has brought about an unprecedented rash of mergers and acquisitions among major business entities in the United States.

I'm writing today to express the concerns of this farm organization about these activities and to ask your help in insuring that the "takeover craze" does not cause irreparable harm to many segments of the U.S. economy.

Recently, the National Farmers Union Board of Directors adopted the enclosed resolution to showcase what we fear are very detrimental effects on the farm economy caused by the fallout from mergers and acquisitions.

Two recent examples of this activity involved food companies -- the Philip Morris acquisition of Kraft foods and the Kohlberg, Krivis, Roberts acquisition of R.J. Reynolds/Nabisco. We at NFU are deeply concerned about the increasing ratio of concentration in the food industry which may prove devastating to the family farmers of this country. The type of vertical integration many food processing and wholesaling entities are practicing today limits the competitiveness of the family farm operators who are the backbone of the industry.

Today, over half the fed cattle being slaughtered in the United States were fed in a handful of giant feedlots owned by major corporations. This same scenario is being played out in the broiler industry and other segments of the food production sector. The effects of this type of consolidation are clearly being felt on our farms and in our rural communities.

Secondly, the financing of acquisitions and mergers through leveraged buyouts is diverting useful investment capital away from needy sectors like agriculture and small business. Takeovers and mergers will use up more than $250 billion in capital this year alone! That money will help build no new plants, purchase no new equipment, and certainly, will not provide any new jobs. That money also becomes unavailable for farm, real estate, automobile, or consumer loans. Since much of the [illegible]over capital is financed through leveraged buyout, junk

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bonds or other means, the buyout binge forces interest rates up and forces farmers and consumers to compete directly with the takeover promoters for financing.

At a time when consumers are scrambling for available housing loans; when the cost of educating our young people is skyrocketing and college loans are increasingly unavailable; when family farmers must struggle each spring to find operating capital at interest rates that eat up their profit; and when servicing the national debt is one of our government's largest budget items, we must insure that available capital is redirected toward more useful purposes.

Please join us in urging the imposition of a drastic limit on the consolidation and the wasteful diversion of capital mergemania has brought about which today threatens the very lifeblood of our country.

Sincerely,

Leland Swenson

Leland Swenson
President

Enclosure

The recent Philip Morris acquisition of Kraft Foods and the Kohlberg, Kravis,Roberts acquisition of R.J. Reynolds/Nabisco raise our concerns for two principal reasons:

First, the increasing ratio of concentration in the food industry will be detrimental to both producers and consumers;

Second, the financing of acquisitions through leveraged buy-outs and merger financing diverts investment capital from more productive purposes.

The Philip Morris purchase price was $1[illegible].5 billions, the Kohlberg, Kravis,Roberts was $25 billions. In the latter case, KKR put in only $15 millions of its own money, financing the remainder.

Altogether, take-overs and mergers will use up more than $250 billions in capital in 1988. This may be profitable for the take-over promoters, but it builds no new plants, purchases no modernized equipment, and usually results in loss of employment.

The loan funds used in mergers and buyouts could more usefully be employed in refinancing farm loans, purchasing homes or buying automobiles or other consumer needs.

Unfortunately, existing federal corporate income tax law provides incentives for take-over financing through junk bonds and other means.

We concur with statements by House Speaker Jim Wright, Senate Finance chairman Senator Lloyd Bentsen, and Federal Reserve Board chairman Alan Greenspan expressing concern about the rash of leveraged buy-outs.

We recommend that the 101st Congress impose a drastic limit upon this wasteful diversion of investment capital and urge the redirection of available capital to useful purposes.

STATEMENT OF STUART H. SAVETT
IN CONNECTION WITH HEARINGS BEFORE THE
SENATE FINANCE COMMITTEE ON JANUARY 24-26, 1989

I am a senior member of Kohn, Savett, Klein & Graf, P.C., and have represented plaintiffs and defendants in securities, antitrust, consumer fraud and other major litigation. As representatives of shareholders and bondholders in numerous public corporations, we are deeply concerned about the ever-increasing mountain of corporate debt. The situation has evolved rapidly in the business arena without any effective regulation by Congress or the courts or assistance from existing statutory or common law, all of which were not designed to address this problem. The federal securities laws were intended to insure full disclosure to investors. State laws, particularly in Delaware where a vast majority of companies are incorporated, are evolving to insure that shareholder values are maximized in takeover situations, and that corporate boards do not use anti-takeover devices inappropriately to preclude shareholders from deciding for themselves whether to accept takeover bids. However, state laws do not adequately protect the shareholder where management makes an offer to take the company private.

It is now time for Congress to address the highly leveraged condition of corporate America, which will have wide-ranging ramifications, including the following:

(1) There are serious uncertainties concerning the ability of highly leveraged corporations to make interest payments in an economic downturn, when interest rates are rising or during inflationary periods. Indeed, it is not certain that, even under satisfactory economic conditions, highly leveraged companies will survive. For example, Revco D.S., Inc. was the first company which underwent a leveraged buyout to seek the protection of the federal bankruptcy laws. As a result of overly optimistic projections of cash flow, earnings and asset sales, Revco defaulted on $700 million of bonds.

(2) Banks which have been and are heavy lenders to leveraged buyout borrowers may face loan losses akin to the losses suffered in the early 1980's by banks making loans to lesser developed countries. For example, Citicorp has an exposure of approximately $4 billion to leveraged buyout borrowers. Not only the occurrence of losses, but the specter of such losses, will further erode public confidence in an already weakened banking system.

(3) Present bondholders in companies which are the subject of leveraged buyouts, such as RJR Nabisco and Federated, suffer the transformation of their bonds from high grade investment quality vehicles into "junk." The public stockholders of these companies, who receive substantial premiums for their stock, do so at the expense of the

bondholders, whose interests are not considered by corporate boards when determining whether to accept a takeover bid.

(4) The highly leveraged condition of numerous post-LBO corporations may cause a reduction in socially valuable expenditures, such as for research and development, and may cause closings of plants and factories. Thus, the basic goals of post-LBO companies will be materially different as a result of their increased debt.

(5) Management of takeover targets reap outrageous financial benefits, in the form of golden parachutes or continuing employment or equity packages, as a result of approving highly leveraged transactions. Their investment advisors profit as well. Therefore, the motives of the people actually responsible for approving and effectuating such deals are highly suspect and it can be assumed that they give top priority to their own financial interests.

(6) The tax laws are at least partially responsible for the vast increases in the issuance of debt instruments in leveraged buyout transactions because interest payments are deductible for the corporation, while dividend payments are not. In effect, the government is subsidizing the leveraging of corporate America and deepening the federal budget deficit -- a result which is highly questionable.

Small
Business
Legislative
Council®

February 9, 1989

The Honorable Lloyd Bentsen
Chairman
Senate Finance Committee
SD-205 Dirksen Senate Office Building
Washington, DC 20510

Dear Mr. Chairman:

On behalf of the Small Business Legislative Council, I wish to submit these brief comments, for the record, of your hearings on leveraged buy-outs (LBOs). The Small Business Legislative Council (SBLC) is a permanent, independent coalition of over ninety trade and professional associations that share a common commitment to the future of small business. Our members represent the interests of over four million small businesses in manufacturing, retailing, distribution, professional and technical services, construction, transportation and agriculture. A list of our members is attached.

While we make no pretense of having the resources to participate fully in the debate regarding whether LBOs should be discouraged, or the appropriate method to limit them if such a goal is deemed worthwhile, we do have a significant stake in the outcome. In particular, we do know that small business does rely heavily on debt financing throughout its lifespan. I can recall, during the many go-rounds regarding the regulations under Internal Revenue Code Section 385, the difficulties in finding an adequate definition to reflect the realities of small business financing.

If Congress considers an approach based on the disallowance of interest, we hope you will make a distinction that will allow small business to continue to use the only source of financing readily available to small business, debt.

We cannot pass the opportunity by without commenting on small business' access to capital. Certainly, a small business sector less reliant on debt would be a more preferable situation. Congress can use this opportunity to enact initatives to reduce small business' reliance on debt, and to stimulate the ready flow of venture capital. Restoration of a capital gains differential, perhaps limited to certain assets and adjusted to reflect the duration of the investment, would improve the equity picture for small business.

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Second, we have long been supporters of the Corporation for Small Business Investment (COSBI), the time for implementation of the concept is long overdue. It will increase the availability of venture capital, and resolve a long-standing budget dilemma.

Finally, small business was involved in an extensive debate held in the Judiciary Committee on the impact of mergers and acquisitions in the late 1970's. Granted, LBOs are but one method of corporate restructuring, but we believe some of the observations applicable then, apply now. Economic diversity is a sound concept whether viewed from the national or local perspective. We must encourage it, not discourage it. While it may be true that a by-product of some LBOs are "new" small businesses spawned from the assets shed by the debt-ladened company, on the whole we must view with suspicion any significant concentration of economic power and any method of restructuring that creates such a concentration.

In sum, it is our hope that Congress will consider, in the course of its deliberations on LBOs, what will the impact be of the problem, and solutions, upon small business.

Sincerely,

John S. Satagaj
President

JSS/S0034
Enclosure

Members of the Small Business Legislative Council

Air Conditioning Contractors of America
Alliance of Independent Store Owners and Professionals
American Association of Nurserymen
American Collectors Association, Inc.
American Consulting Engineers Council
American Council of Independent Laboratories
American Dental Trade Association
American Floorcovering Association
American Machine Tool Distributors Association
American Road Transportation Builders Association
American Society of Travel Agents, Inc.
American Sod Producers Association
American Subcontractors Association
American Textile Machinery Association
American Trucking Associations, Inc.
American Warehousemen's Association
Architectural Precast Association
Associated Builders & Contractors
Associated Landscape Contractors of America
Association of Physical Fitness Centers
Association of Small Business Development Centers
Association of the Wall and Ceiling Industries-International
Automotive Service Association
Building Service Contractors Association International
Business Advertising Council
Christian Booksellers Association
Council of Fleet Specialists
Electronics Representatives Association
Florists' Transworld Delivery Association
Helicopter Association International
Independent Bakers Association
Independent Bankers Association of America
Independent Medical Distributors Association
Independent Sewing Machine Dealers Association
International Association of Refrigerated Warehouses
International Bottled Water Association
International Communications Industries Association
International Fence Industry Association
International Franchise Association
Latin American Manufacturers Association
Machinery Dealers National Association
Manufacturers Agents National Association
Mechanical Contractors Association of America, Inc.
Menswear Retailers of America
National Association for the Self-Employed
National Association of Brick Distributors
National Association of Catalog Showroom Merchandisers
National Association of Chemical Distributors
National Association of Development Companies
National Association of Home Builders
National Association of Investment Companies
National Association of Manufacturing Opticians
National Association of Personnel Consultants
National Association of Plumbing-Heating-Cooling Contractors
National Association of Realtors
National Association of Retail Druggists
National Association of Small Business Investment Companies
National Association of the Remodeling Industry
National Association of Truck Stop Operators
National Association of Women Business Owners
National Candy Wholesalers Association
National Campground Owners Association
National Chimney Sweep Guild
National Coffee Service Association
National Council for Industrial Innovation
National Electrical Contractors Association
National Fastener Distributors Association
National Grocers Association
National Knitwear & Sportswear Association
National Independent Dairy-Foods Association
National Lumber & Building Material Dealers Association
National Machine Tool Builders' Association
National Moving and Storage Association
National Office Products Association
National Paperbox & Packaging Association
National Parking Association
Professional Plant Growers Association
National Precast Concrete Association
National Shoe Retailers Association
National Society of Public Accountants
National Tire Dealers & Retreaders Association
National Tooling and Machining Association
National Tour Association
National Venture Capital Association
Opticians Association of America
Petroleum Marketers Association of America
Printing Industries of America, Inc.
Professional Plant Growers Association
Retail Bakers of America
Small Business Council of America, Inc.
Smaller Manufacturers Council
Society of American Florists
Specialty Advertising Association International
The National Association of Passenger Vessel Owners
United Bus Owners of America

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